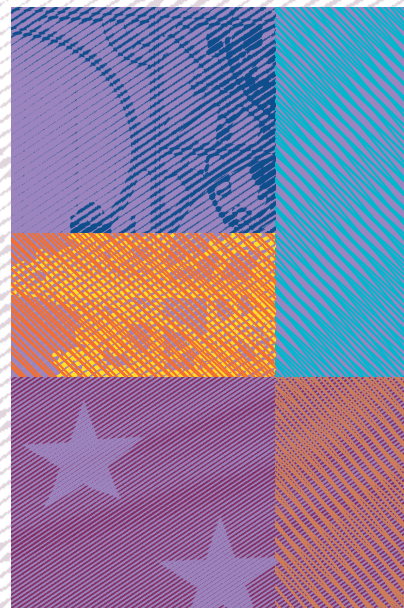


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QUARTERLY REPORT ON THE SPANISH ECONOMY

1 OVERVIEW

Activity in the world economy suffered a certain loss of momentum in the latest period, while the heterogeneity across geographical areas increased. Among the advanced economies, the United States was more buoyant than other regions, while among the emerging economies, the relative strength of the Asian economies contrasts with the weakness of activity in Latin America and in central and eastern Europe. Also, the latest indicators point to a sharp slowdown in world trade in recent months.

There were significant developments on international financial markets during the summer months. In particular, the currencies of the emerging economies depreciated significantly, with particularly sharp falls in the Turkish lira and the Argentine peso, currencies that were especially vulnerable because of their countries' high levels of dollar-denominated foreign debt. In addition, there were falls – in some cases very sizeable – on the equity and debt markets of emerging countries, in contrast to the stability of US debt yields and the strength of the US stock market.

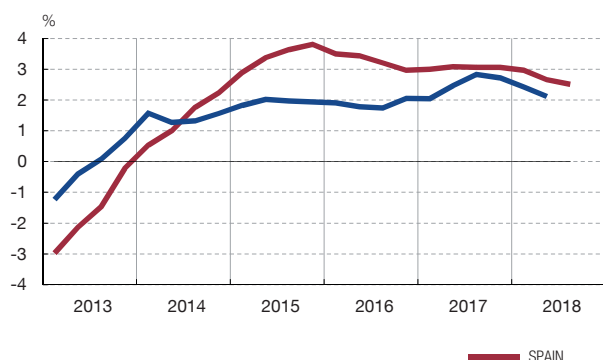
The developments in global activity and financial markets described above seem to reflect a partial materialisation of certain risks to the outlook for world activity that have been present for a number of quarters. First, it is possible that, through an increase in uncertainty, the protectionist threats have begun to affect trade and, perhaps, agents' spending decisions. Second, and probably more importantly, the economic policy mix in the United States, characterised by the process of normalisation of monetary policy and a pro-cyclical fiscal expansion, may have begun to have negative consequences, through the upward pressure it puts on US interest rates and on the dollar and the reduction in global liquidity it entails, both for flows of financing to other economic areas and for the cost of such financing. Looking ahead, the expansion of the world economy is expected to continue, against a background in which monetary policies remain accommodative, although recent developments have led to some downward revision of the prospects for world trade and activity.

The divergence in economic developments in the various geographical areas has extended to prices, with an increase in core inflation in the United States, but not in the other advanced economies, and very pronounced rises in emerging economies that have experienced sharp exchange rate depreciation.

In the euro area, the reduced buoyancy of activity seen in the first quarter was again seen in the second. Weakening world trade, together with the impact of the past exchange rate appreciation, reduced the contribution of net external demand to GDP growth, to negative levels in the first half of the year. It is projected that, in the medium term, the persistence of favourable financial conditions and the improvement in the financial situation will continue to be conducive to the expansion of domestic demand, although it cannot be ruled out that this will eventually be affected by the increase in uncertainty linked to developments in the rest of the world.

As regards consumer prices, the impact of past increases in the oil price on the year-on-year rate of inflation will tend to disappear over the coming months. On the other hand, core inflation is expected to rise, with a widening positive output gap continuing to translate gradually into increases in wage growth, as has already begun to occur in recent quarters. The latest projections of the European Central Bank (ECB) envisage a slight deceleration

1 GROSS DOMESTIC PRODUCT



2 HARMONISED INDICES OF CONSUMER PRICES



SOURCES: Eurostat, INE and Banco de España.

a Year-on-year rates of change based on seasonally adjusted series in the case of GDP and on original series in the case of consumer price indices.

in euro area GDP growth, from 2% in 2018 to 1.7% in 2020, a downward revision of 0.2 percentage points (pp) in cumulative terms with respect to the Eurosystem's June projections. Meanwhile, the average annual inflation rate is expected to rise to 1.7% in the three-year period 2018-2020

Albeit less sharply than in the euro area as a whole, the growth rate of the Spanish economy has also slipped recently. On preliminary estimates, GDP grew at a quarter-on-quarter rate of 0.6% in Q2, down 0.1 pp from Q1. This mild slowdown is attributable to the loss of momentum of private consumption and the weakness of foreign trade. The latest information suggests that the growth rate in Q3 may have held steady at 0.6%.

In the medium term, according to the update of the Banco de España's macroeconomic projections presented in Box 1 of this report, the current economic upturn will continue over the period 2018-2020. This favourable outlook is based on the progress made in correcting the macro-financial imbalances, with the improvement in external competitiveness having been fundamental, insofar as it has enabled sustained GDP growth to be compatible with a persistently positive external balance. That said, the growth rate of GDP is expected to continue to moderate gradually over time, as the stance of demand policies becomes less expansionary. Specifically, having grown at a rate of 2.6% in 2018, the economy is expected to grow by 2.2% in 2019 and by 2% in 2020.

These projections involve a certain downward revision of those presented in June, as a consequence of the impact on exports of the deterioration in the external environment, which will eventually also have adverse effects on household and corporate spending. Moreover, the balance of risks to the central scenario of the projections is on the downside. On the external front, an intensification of the tightening of global financial conditions, leading to new episodes of instability on the most vulnerable emerging markets and a consequent adverse impact on global activity, cannot be ruled out. Among the other risks arising from the external environment, the threat of further protectionist measures is also notable. On the domestic front, as in previous quarters, there is a notable degree of uncertainty regarding the future economic policy stance, against a background of considerable parliamentary fragmentation. Also, a hypothetical increase in uncertainty, associated with the political situation in Catalonia, continues to represent an additional risk to economic stability especially in that region.

	2016	2017	2017				2018		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
National Accounts									
Quarter-on-quarter rates of change, unless otherwise indicated									
Gross domestic product	3.3	3.1	0.8	0.9	0.7	0.7	0.7	0.6	0.6
Contribution of national demand (b)	2.5	2.8	1.1	0.7	0.8	0.6	0.7	0.8	0.6
Contribution of net external demand (b)	0.7	0.3	-0.3	0.2	-0.1	0.1	0.0	-0.2	-0.1
Year-on-year rates of change									
Employment	3.0	2.8	2.6	2.9	2.9	2.9	2.6	2.5	2.2
Price indicators (y-o-y change in end-of-period data) (c)									
HICP	-0.3	2.0	2.1	1.6	1.8	1.2	1.3	2.3	2.2
HICP excl. energy and food	0.7	1.2	0.8	1.4	1.3	0.9	1.2	1.0	0.9

SOURCES: INE and Banco de España.

a Information available to 24 September 2018.

b Contribution to the quarter-on-quarter rate of change of GDP (pp).

c Latest available figure for consumer price indices: August 2018.

With regard to inflation, the indicator of overall consumer prices has shown rates of growth of around 2% in recent months. However, according to measures of core inflation (like the one that excludes energy and food), price growth is considerably lower, standing at around 1%, against a background of deceleration in the services component. As in the euro area as a whole, the decline in cyclical slack over the projection period is expected to result in a gradual rise in the indicator of core inflation.

There are seven boxes in this report. The first describes the basic features of the macroeconomic projections for the Spanish economy. The next three address issues relating to the external environment of the Spanish economy, analysing recent developments in emerging economies, evaluating the implications of the shift towards more expansionary policies in China and assessing the possible role that supply restrictions may play in the euro area given its current position in the cycle. The last three boxes focus on issues relating to the Spanish economy, assessing the outlook for the saving rate, analysing the slowdown in non-resident tourism during 2018 and describing the recent developments in the consumer credit market.

This box contains the update to the Banco de España's macroeconomic projections for the Spanish economy published on 15 June,¹ including information that has become available since then. Specifically, the projections presented here incorporate the preliminary results of the Quarterly National Accounts for the second quarter of 2017, and the changes observed in the assumptions on which the projections are based (see Table 1).²

The current projections foresee the growth phase that began in late 2013 continuing over the period 2018-2020. This outlook for a continuation of the current economic expansion is supported by progress on correcting macro-financial imbalances. In particular,

- 1 Macroeconomic projections for the Spanish economy (2018-2020): the Banco de España's contribution to the Eurosystem's June 2018 joint forecasting exercise.
- 2 The June publication was based on the information for the variables underlying the forecasts available as at 22 May. In the case of the current projections, the information referring to developments in Spain's export markets is that prepared by ECB staff for the publication of the *ECB staff macroeconomic projections for the euro area, September 2018*, for which the cut-off date was 21 August. For their part, the data on the remainder of the assumptions used in preparation of the projections were updated on 14 September. Finally, information available as at 21 September was used in the preparation of the projections. However, explicit use has not been made of the information in the revised Annual National Accounts published by the National Statistics Office (INE) on 6 September. The reason is that the models used to prepare the projections require quarterly series, and on the cut-off date for these projections quarterly series consistent with the latest annual information were not yet available.

the economy's competitiveness gains have allowed the composition of GDP to be refocused from the demand-side perspective towards exports, making it possible for the expansion of activity and reduction of prevailing high levels of unemployment to be compatible with maintaining an external surplus. At the same time, private agents have been able to reconcile their spending plans with a reduction in their debt.

Against this positive backdrop, it is expected that the economy will continue to grow at above its potential rate, supported by the expansionary stance of demand-side policies, as reflected in the persistence of the accommodative monetary policy stance and, in the short term, the budgetary policy measures set out in the 2018 State Budget.

Nevertheless, it is expected that output growth will tend to moderate over the course of the projection horizon. From the standpoint of demand-side policies, the projected upturn in euro-area inflation resulting from the gradual widening of the output gap, reduces the likelihood of there being additional monetary stimulus, although the effects of the monetary policy measures implemented in recent years will continue to be felt. Additionally, the projection exercise assumes that the expansionary fiscal policy measures adopted in the first half of the year will support growth over the period 2018-2019, while in the absence of medium-term budgetary plans, fiscal policy is assumed to take a neutral stance in the final year of the projection. Lastly, the household saving rate is expected to recover from its current levels close to its all-time low, leading to

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change, unless otherwise indicated

	2017	September 2018 projections			Difference between the current projections and those made in June 2018 (b)		
		2018	2019	2020	2018	2019	2020
International environment							
World output	3.6	3.7	3.5	3.4	-0.1	-0.2	0.0
Spain's export markets	4.9	3.5	3.8	3.7	-0.9	-0.5	-0.1
Oil price in dollars/barrel (level)	54.4	73.4	75.5	71.9	-1.1	2.0	3.2
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.13	1.19	1.16	1.16	-0.01	-0.02	-0.02
Spain's nominal effective exchange rate vis-à-vis the world including the euro area (2000 = 100 and percentage differences) (c)	114.6	117.9	118.6	118.6	0.5	1.1	1.1
Short-term interest rate (3-month EURIBOR) (d)	-0.3	-0.3	-0.2	0.1	0.0	-0.1	-0.2
Long-term interest rate (10-year bond yield) (d)	1.6	1.4	1.7	2.0	-0.1	-0.1	-0.1

SOURCES: ECB and Banco de España.

- Assumptions cut-off date: 14 September 2018. The figures expressed as levels are annual averages; the figures expressed as rates are calculated based on the relevant annual averages.
- Differences are between rates in the case of world output and export markets, between levels in the case of oil prices and the dollar/euro exchange rate, percentage differences for the effective nominal exchange rate and percentage point differences in the case of interest rates.
- A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
- For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

a further moderation in consumer spending in addition to that seen since 2017. The short-term information available suggests that GDP growth in the third quarter may have been 0.6%, as in the second quarter. The slight growth moderation forecast for the following quarters would slow output growth from 2.6% in 2018 to 2.2% and 2% in each of the two following years.

Inflation is projected to follow a downward path in annual average HICP growth terms over the projection horizon, with rates of 1.8%, 1.7% and 1.5%, respectively, in each of the three years considered.³ This downward trajectory of the headline indicator is mainly driven by the slowdown in the energy component, primarily explained by the downward oil futures curve. By contrast, the core

inflation component is expected to pick up as the period in which output is expanding at above its trend rate continues and leads to ever higher capacity utilisation. Specifically, HICP excluding energy and food, is projected to rise by 1% this year, before accelerating to 1.4% and 1.8% in the following two years.

Overall, relative to the June projections, the changes in the assumptions underlying the forecast have a negative impact on activity and an approximately neutral impact on prices. The most significant change in the assumptions is the markedly less dynamic

derived from it by excluding prices of energy and unprocessed food, as an accompanying measure of core inflation (IPSEBENE, by its Spanish abbreviation). The note "Reference variables for analysing inflation in Spain" explains why the DGEE opted to replace the previous measures by the Harmonised Index of Consumer Prices (HICP), as an overall measure of changes in consumer prices, and the indicator derived from it excluding energy and food prices, as a measure of changes in core inflation.

3 Until recently, the benchmark variables used by the Directorate General Economics, Statistics and Research (DGEE) of the Banco de España to analyse and forecast the behaviour of consumer prices in Spain were the national definition of the consumer price index (CPI) and an index

Table 2
PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACRO MAGNITUDES (a)

Annual rate of change in volume terms and % of GDP

			September 2018 projections			Difference between the current projections and those made in June 2018		
	2017 (b)	2017	2018	2019	2020	2018	2019	2020
GDP	3.0	3.1	2.6	2.2	2.0	-0.1	-0.2	-0.1
Private consumption	2.5	2.4	2.2	1.6	1.5	-0.2	-0.2	-0.2
Government consumption	1.9	1.6	1.9	1.5	1.2	0.4	0.1	0.0
Gross fixed capital formation	4.8	5.0	5.1	4.1	3.9	0.8	-0.2	-0.1
Investment in capital goods	5.7	6.1	5.1	3.8	3.7	2.6	-0.4	-0.3
Investment in construction	4.6	4.6	5.5	4.4	4.3	-0.1	0.0	0.0
Exports of goods and services	5.2	5.0	2.6	3.9	4.1	-2.0	-0.9	-0.4
Imports of goods and services	5.6	4.7	3.1	4.0	4.0	-1.4	-0.6	-0.5
National demand (contribution to growth)	2.9	2.8	2.7	2.1	1.9	0.2	-0.1	-0.1
Net external demand (contribution to growth)	0.1	0.3	-0.1	0.1	0.1	-0.3	-0.1	0.0
Nominal GDP	4.3	4.0	3.7	3.9	3.8	-0.5	-0.2	-0.2
GDP deflator	1.2	1.0	1.0	1.7	1.8	-0.4	0.0	-0.1
Harmonised index of consumer prices (HICP)	2.0	2.0	1.8	1.7	1.5	-0.2	0.0	-0.1
HICP excluding energy and food	1.2	1.2	1.0	1.4	1.8	-0.4	-0.3	-0.2
Employment (full-time equivalents)	2.9	2.8	2.4	1.9	1.7	0.0	-0.2	-0.2
Unemployment rate (% of labour force). End-of-period data	16.5	16.5	14.6	13.2	11.9	0.0	0.2	0.5
Unemployment rate (% of labour force). Average data	17.2	17.2	15.3	13.8	12.4	0.1	0.4	0.6
Nation's net lending (+) / net borrowing (-) (% of GDP)	—	2.0	1.3	1.1	1.1	-0.3	-0.5	-0.4
General government's net lending (+) / net borrowing (-) (% of GDP)	—	-3.1	-2.8	-2.5	-2.2	-0.1	-0.2	-0.2

SOURCES: Banco de España and INE.
Latest QNA data: 2018 Q2.

a Projections cut-off date: 21 September 2018.

b The rates of change in 2017 that refer to the National Accounts series have been updated to include the revision of the Annual National Accounts for the years 2015-2017 published by the INE on 6 September. The new figures for net lending / net borrowing of the nation and of the general government will be published on 28 September.

performance of export markets, with expected growth 1.5 pp lower in cumulative terms over the period 2018-2020 than was projected three months ago. This deterioration in the outlook for global trade and activity is more pronounced in the case of the more vulnerable emerging market economies, which have started to feel the effects of the uncertainty generated by the successive announcements of the introduction of protectionist measures, and also of the tightening financial conditions in these economies, resulting from the shift towards a less expansionary monetary policy stance in the United States.⁴ Moreover, measured in euro, the oil price is now projected to be higher in 2019 and 2020, which also helps explain the weakening of the Spanish economy's momentum compared to the June projections. Conversely, the downward revision of short and long-term interest rates, in line with the expectations implicit in the yield curves, results in a slight cheapening of lending to households, according to the equations linking bank lending rates to these market rates.

There are only minor changes to the public finance assumptions over the projection horizon compared to the previous exercise. Fiscal policy projections for 2018 are based on measures adopted in the budgets of the various different tiers of government for this year,⁵ together with the available information on their execution. As regards the assumptions for the remainder of the projection horizon, on the cut-off date for these projections, the draft 2019 State and Social Security budget had not been submitted. This being the case, we opted to use various technical assumptions to estimate the fiscal variables for the period 2019-2020. First, the impact of the measures approved in 2018, but with effects on the following years, was considered, such as the 2019 pension increase of 1.6% adopted in the 2018 State budget, the public sector employment and salary agreement between the government and main unions in the sector for the period 2018-2020, and the deferred effects of changes in personal income tax regulations. Second, it was assumed that those budgetary items subject to greater discretionality – such as public investment and procurement, in particular, given their volume – will grow in line with the nominal growth potential of the Spanish economy.⁶ Finally, it was assumed that, in the absence of specific measures, the course of the remaining items in the general government accounts will be shaped by the usual factors.⁷

According to these assumptions and forecasts of the fiscal policy variables and the output gap estimated in a way consistent with the other macroeconomic projections, the fiscal policy stance is expected to be expansionary in 2018 and 2019, after its approximately neutral stance in 2017.

Current GDP growth projections entail downward revisions from the previous projection of 0.1 pp, 0.2 pp and 0.1 pp in 2018, 2019 and 2020, respectively. The scale of the revision is similar to that which, based on historical evidence, would derive from the impact of the changes in the various assumptions shaping the projection.⁸ This is mainly a consequence of the worsening outlook for developments in Spain's export markets and, to a lesser extent, rising oil prices. By contrast, the further cut in the cost of borrowing by private agents exerts a slightly expansionary effect.

As in the case of GDP, the sign of the revision of the main demand components is also negative in cumulative terms over the projection horizon as a whole.⁹ First, the worse expected performance of export markets translates into less buoyant exports. Also, the drop in external demand and the adverse effects of the increased uncertainty from the international environment on private agents' spending decisions have led to a slight downward revision of the main components of domestic demand. In turn, weaker final demand goes hand in hand with weaker imports.

Regarding inflation, the current projections for HICP growth represent a downward revision of 0.2 pp in 2018 and of 0.1 pp in 2020, while the annual average projected for 2019 remains unchanged. These relatively modest revisions are influenced by a combination of factors of opposite signs. Specifically, the energy component has been revised up over the entire projection horizon. In the near term, this is because, in recent months, energy prices have shown a more dynamic performance than was estimated in the previous projection exercise, while the higher energy goods inflation expected over the rest of the projection horizon is due to the higher expected levels of crude prices according to the futures markets. The projections for the core HICP component (which excludes energy and food prices) have been revised down as a result of the weaker demand momentum and the recent forecasting errors in this component, especially as regards services, which suggest that the response of inflation to the widening of the output gap could be more moderate than foreseen to date in the projections.

As has been the case since the start of the recovery, expenditure on consumer goods and services is expected to continue to be

⁴ See Box 2 (Recent turbulence in emerging markets) in this edition of the Quarterly report on the Spanish economy.

⁵ For a detailed description, see Box 5 of the [Quarterly report on the Spanish economy 2/2018 \(June\)](#).

⁶ In a similar vein, the general government investment forecast for 2019 includes the estimate stated in the Stability Programme 2018-2021 of income in the order of €1 billion for the re-tendering of toll motorways that were taken under government management as a result of the bankruptcy proceedings this year.

⁷ Specifically, it is assumed that government revenue will grow in line with tax bases, which mainly depend on the macroeconomic context. Similar assumptions are made for those less discretionary expenditure items. This is the case of pensions (basically driven by population ageing and, in 2020, by the pension revaluation index, the revaluation formula established in the current legislation), unemployment benefits (which depend mainly on changes in the unemployment rate) and interest (which changes according to the level of government debt and interest rates).

⁸ Moreover, the preliminary Quarterly National Accounts (QNA) data for 2018 Q2 estimate the Spanish economy's output growth in the period to have been 0.6% in quarter-on-quarter terms. This is 0.1 pp lower than expected in the June projections, which also has a negative impact on the average GDP growth rate for the year as a whole.

⁹ Nevertheless, in the case of certain demand components (investment in capital goods, in particular), the preliminary estimate from the second quarter QNA was a positive surprise, with an automatic effect of the same sign on average annual growth rates in 2018, tending to offset the adverse impact of the new assumptions for this year.

underpinned by the favourable labour market performance, the steady improvement in households' financial wealth (assisted by the gradual deleveraging process) and the continued favourable financial conditions, in terms both of the availability and the cost of borrowed funds, reflected in the growing proportion of credit-based consumer spending.¹⁰ In addition, especially in the near term, households' current expenditure will benefit from the positive effect on households' income of the entry into force of various budgetary measures contained in the State budget for 2018, such as the salary increase for public sector employees, the more dynamic employment performance in the general government sector or the decisions adopted on revaluation of pensions.

Nevertheless, private consumption is expected to decelerate over the projection horizon, as the result of a combination of a variety of factors. First, the projected slowdown in GDP will, naturally, be accompanied by slower employment generation. Second, although in terms of labour income growth the projected acceleration in real wages will tend to offset the lower employment momentum expected, the composition of that labour income growth over the projection horizon will tend to become less favourable to household expenditure than it was in the past, given that, on the evidence available, consumer spending tends to be less responsive when a given increase in labour income stems from rising real wages rather than from rising employment. Lastly, the reversal of some of the factors that have driven down the saving rate in recent years will also help to moderate the pace of growth of private consumption.¹¹

Residential investment is set to continue to record high rates of growth, against a backdrop of continued highly favourable conditions for taking out mortgages. However, some deceleration in this demand component is expected over the projection horizon, since the strong pace of growth in the recent period, combined with the decline in the saving rate, has led to the emergence of household net borrowing (albeit on a small scale). In the projection period, the increase in saving and the lower momentum of residential investment will allow household net borrowing to stabilise around its current levels. Business investment will be encouraged by the plentiful generation of internal funds and the availability of low-cost funding, but this component will also decelerate somewhat, in keeping with the lower final demand momentum. In addition, the heightened uncertainty about the global economy will also tend to hold back non-financial corporations' investment decisions.

Sales of non-tourism goods and services to the rest of the world are expected to grow relatively moderately over the projection horizon, in keeping with the deterioration of the outlook for foreign markets. Nevertheless, exports of these products should continue to grow slightly faster than their destination markets, as a result of the increase

in the number of firms which, once they have begun to export to a certain market, are able to continue to do so years later and to substantially increase the volumes sold. As for exports of tourism services, after the recent slowdown linked to the recovery of various alternative destinations and, to a lesser extent, to the signs of saturation in certain areas of Spain, rates of growth are expected to stabilise over the projection horizon.¹² Lastly, in the case of imports, it continues to be assumed that they will grow at a slightly slower pace than their historical relationship with final demand would warrant.

Employment will continue to record the high growth rates that are customary in upturns in the Spanish economy, allowing the unemployment rate to drop somewhat below 12% by the end of the projection horizon.

The economy's net lending position, which in 2017 amounted to 2% of GDP, will decline this year to around 1.3% and is expected to remain close to that figure over the rest of the projection horizon. This moderation in the external balance, concentrated on the balance of goods and services, would be as a result both of the deterioration observed this year in net trade flows in real terms and the deterioration in terms of trade, against a backdrop of rising oil prices. It is estimated that the budget deficit could amount to 2.8% of GDP this year, 0.1 pp more than envisaged in the June projections, given that the slowdown in activity in the final stretch of the year is expected to affect the strength of tax bases and, therefore, tax revenue. In subsequent years, under the assumptions described above and the favourable cyclical conditions, the budget deficit may be expected to experiment a further slight decline.

The current projections for consumer prices point to a gradual increase in core inflation, measured by the annual rate of change in the HICP excluding energy and food, from 1% in 2018 to 1.8% in 2020. This increase is consistent with the projected widening of the positive output gap, given that GDP is expected to grow above its potential rate throughout the projection period. From the cost standpoint, it is estimated that wage growth will tend to accelerate as labour market slack decreases and in line with the recommendations of the Employment and Collective Bargaining Agreement for 2018-2020 entered into by the social partners in June. This gradually increasing rate of growth in wages can be expected to pass through to unit labour costs, since no significant increase in productivity above its current low rates is expected over the projection period. In addition, it is estimated that profit margins (measured as the difference between the rates of growth of the GDP deflator and unit labour costs) will stabilise. External inflationary pressures, which have been high in 2018 as a result of higher oil prices, should moderate significantly in coming quarters, in keeping with the path of oil prices on the futures markets, an effect that will dominate the expected trajectory of consumer prices in the period. Overall, the HICP is expected to rise by 1.8% this year, peaking in Q3, before starting to decelerate, to reach 1.7% in 2019 and 1.5% in 2020.

¹⁰ See Box 7 (Recent developments in the consumer credit market in Spain) in this edition of the Quarterly report on the Spanish economy.

¹¹ See Box 5 (The household saving rate in Spain: developments and outlook) in this edition of the Quarterly report on the Spanish economy.

¹² See Box 6 (The slowdown in non-resident tourism in 2018 to date) in this edition of the Quarterly report on the Spanish economy.

The risks to the baseline scenario for growth in activity are on the downside. On the external front, two of the risks identified in previous projection exercises – the adverse repercussions of the US economic policy mix on global financial conditions and the application of trade protectionism measures – have started to materialise and have already had an impact on the baseline scenario, triggering a downward revision of the ECB staff projections for GDP growth worldwide and for the euro area and of the Banco de España's projections for the Spanish economy. However, it is still possible that these two elements may have a more negative impact in the future. Other external risk factors for the Spanish economy are a hypothetical “no deal” outcome from the ongoing negotiations between the United Kingdom and the European Union to establish the framework for their future relations and for the transition period, and also the possible resurgence of concerns regarding the future trajectory of Italian budgetary policy.

On the domestic front, there is still a high level of uncertainty regarding the future economic policy stance, in view of the current parliamentary fragmentation. In addition, a hypothetical increase in uncertainty associated with the tense political situation in Catalonia poses an added risk to economic growth, particularly in Catalonia itself.

The limited progress made to date in the necessary process of correcting the high level of public debt remains an important

element of vulnerability. Against the present backdrop of fiscal policy uncertainty, it should be stressed that decisions on spending instruments and public revenue must be compatible with the need to reduce public debt and to create some headroom for the introduction of stabilising fiscal policy measures should the macroeconomic situation deteriorate. In addition, the instruments to be used to underpin the necessary fiscal consolidation process should minimise, insofar as possible, any potential adverse effects on economic growth.

Moreover, it is also necessary to reinstate a structural reform agenda, to boost the efficiency of the main factor and product markets. This agenda should have two main priorities: first, to correct aspects of the judicial and institutional framework that are sapping the Spanish economy's growth potential; and second, to preserve the regulatory measures that were introduced in response to the crisis, which have underpinned the strength of the recovery and have, via competitiveness gains, made it compatible with an external surplus and strong job creation.

The risks to inflation in the baseline scenario are slightly on the downside, as a consequence of a hypothetical materialisation of the risks of the same sign weighing on activity. By contrast, if any of the currently latent geopolitical conflicts were to intensify, the prices of imported goods, and especially of energy inputs, could rise, with the consequent upward impact on consumer prices.

Since the episode known as the “taper tantrum”¹ in May 2013 until last spring emerging markets have remained notably stable. Although there were some negative reactions to both global and idiosyncratic shocks, over time these became less substantial, shorter and more restricted to a smaller geographical area (see Chart 1). The decrease in the vulnerabilities of these economies in various aspects – such as the reduction of political instability, the greater soundness of their banking systems or their lower dependence on external financing –, the absence of monetary policy surprises in the advanced markets and the rebound of growth and global commerce explain, to a large extent, these developments.

However, the situation changed in mid-April 2018. In the United States, the interaction between the process of monetary policy normalisation and the fiscal expansion approved by the current administration led to an increase in short and long-term rates, to substantial capital inflows and to a strong appreciation of the dollar, factors which have tightened global financial conditions. This new environment is particularly adverse for emerging economies which still have strong external imbalances (high current account deficits and external debt) and relatively low volumes of international reserves.

The deterioration in the emerging financial markets became more pronounced during the summer months, in the face of growing concerns associated with the adoption of protectionist measures and rising geopolitical tensions. The worsening occurred in two phases, with an initial temporary episode of increased volatility around mid-June and a subsequent one, starting at end-July, triggered by the problems specific to Argentina and Turkey and, to a lesser extent, by those of other large emerging market economies. This led, in the third quarter of the year, to a strong outflow of capital (\$25 billion, especially in equities – see Chart 2) and a stagnation of fixed-income issuance (declining by 54% in comparison with summer last year).

Although most emerging countries were affected by these events, some degree of market discrimination has been observed (see Chart 3). Thus, the countries whose stock market prices underwent more corrections were those that were more integrated in global trade and, in particular, in China’s production chain. Specifically, the Asian stock market as a whole fell from mid-April by 11% (with sharper declines in Hong Kong, Korea and China). The currencies which depreciated the most against the dollar were those of countries with more internal or external vulnerabilities, such as the Argentine peso (-29%), the Turkish lira (-27%), the South African rand (-13%) the Russian rouble (-11%) and the Brazilian real

(-8.5%) (see Chart 4). Conversely, the Mexican peso appreciated by almost 7% since mid-June, following the presidential elections and the preliminary agreement reached for a new trade deal with the United States. In contrast with these changes in the stock market and exchange markets, sovereign spreads and the implied probability of default in sovereign CDS prices have hardly changed, except in Turkey and Argentina.

Overall, the magnitude of the most recent phase of turbulence is comparable to that observed when the Chinese stock exchange experienced a profound correction in 2015, although it is still clearly milder than that evidenced during the “taper tantrum” (see Chart 1). Also, unlike during that event, a widespread sell off has not been observed yet. The factors that are containing the effects of the current bout of volatility on the emerging economies as a whole include the high volume of international reserves – which, excluding China, is very close to the all-time high in 2013 (see Chart 5) –, the improvement in economic fundamentals and, especially, the authorities’ response to the turbulence.

However, Turkey and Argentina, the two most affected economies, have certain idiosyncratic elements of vulnerability. In Turkey – where GDP grew by 7.3% in 2017, inflation is around 18% and the current account deficit stands at around 6% of GDP – the main source of vulnerability comes from foreign currency indebtedness of the private non-financial sector, partly channelled through banks whose balance sheets display a very high and growing short-term debt burden in foreign currency, which is reflected in a strong worsening of their net external position (see Chart 6). Dependence on external finance has grown as a result of the guarantees provided by the State for the granting of certain loans. Although banks’ net foreign currency funding positions were provisioned in their balance sheets, some of these foreign currency loans were granted to firms in non-tradable sectors for which, therefore, there are few natural hedges against the strong exchange rate depreciation currently experienced by this economy, which could derive in an increase in non-performing loans. Against this backdrop, uncertainties about central bank independence and the mounting political tension with the United States, which led to a series of trade sanctions, triggered a very negative reaction in the markets. Initially, the response from the authorities focused on alleviating the banking sector’s situation at short term. Regulatory changes easing the classification criteria for loans in default were introduced, the calculation of capital at non-current exchange rates was allowed and the cost of short positions in lira was increased, thereby providing liquidity to the system through the reduction of reserve requirements. Additionally, a bilateral loan was arranged with Qatar, which announced a €15 billion direct investment in Turkey, and the two central banks entered into a swap agreement for an additional €3 billion.

In Argentina, both the sources of vulnerability and the response from the authorities were different. Specifically, it was the public sector which had significantly increased its foreign indebtedness in recent years, thanks to ample international liquidity and a high global appetite for risk (see Chart 7). The new government aimed to reduce the large inherited imbalances through a budgetary programme

¹ “Taper tantrum” is the term used for the period of instability in the financial markets which followed the Federal Reserve’s announcement that it would gradually reduce the volume of Treasury bond purchases within the framework of its quantitative easing programme. The financial markets reacted to this announcement with a strong appreciation of the dollar against emerging economies’ currencies and high capital outflows from these economies.

Chart 1
MARKET REACTION DURING EPISODES OF TURBULENCE (a)

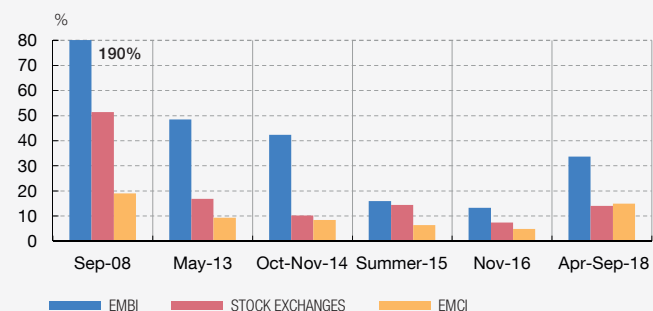


Chart 2
CHANGES IN CAPITAL FLOWS (b)

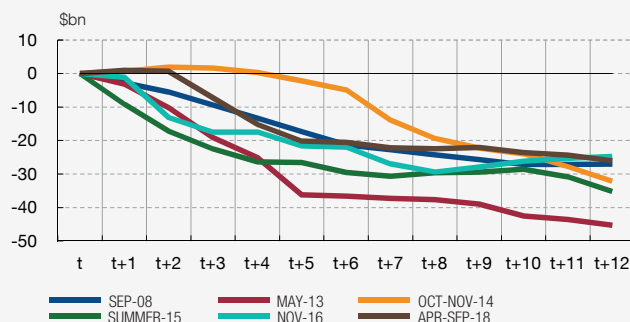


Chart 3
EMERGING MARKET STOCKS



Chart 4
EXCHANGE RATES AGAINST THE DOLLAR

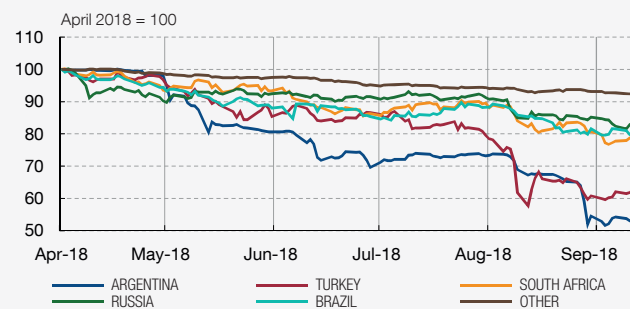


Chart 5
INTERNATIONAL RESERVES

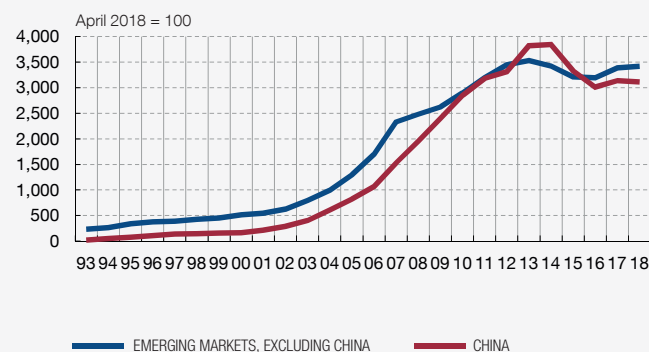


Chart 6
VULNERABILITY INDICATORS IN TURKEY (c)

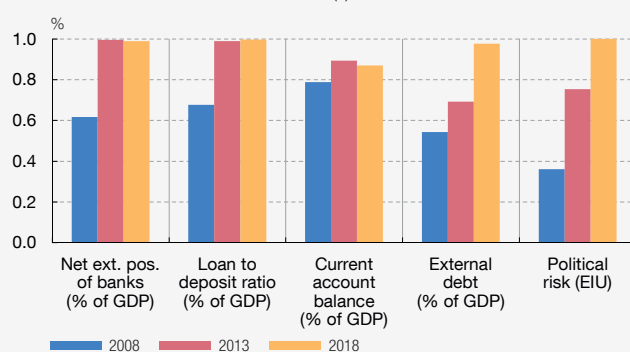


Chart 7
VULNERABILITY INDICATORS IN ARGENTINA (c)

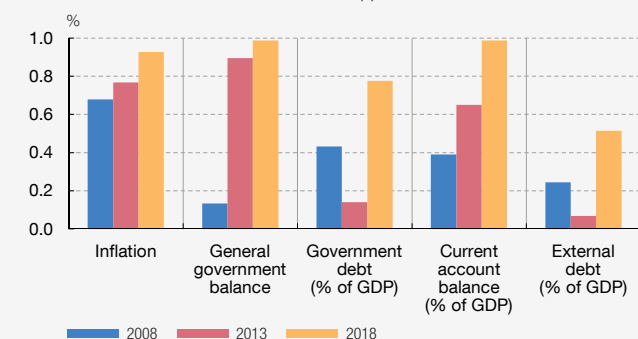
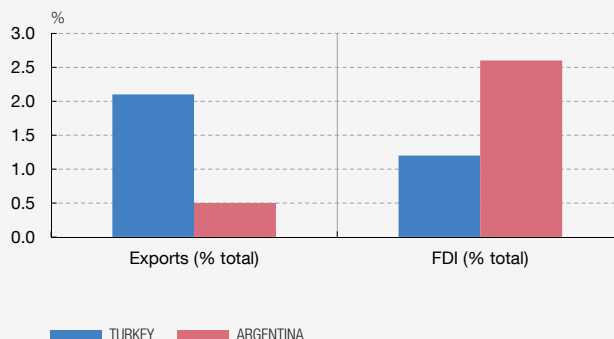


Chart 8
SPAIN'S EXPOSURE TO TURKEY AND ARGENTINA



SOURCES: Banco de España, Datastream, IIF and JP Morgan.

a The bars denote an increase in the risk premium, falls in stock markets and exchange rate depreciation. The dates refer to the collapse of Lehman Brothers (September 2008), the taper tantrum (May 2013), the plunge in oil prices (October and November 2014), China's stock market crash (July and August 2015) and Trump's US presidential election victory (November 2016).

b Weekly changes following the onset of the event indicated in note (a).

c Risk percentile in a historical distribution since 1993 where each indicator was plotted for each of the years represented. An increase denotes an increase in risk.

whose pace of adjustment was so gradual that it was hardly able to reduce the structural primary deficit. Confidence in the correction of imbalances was further damaged when the government eased its inflation targets and the central bank lowered interest rates. Against this background, tightening international financial conditions and a severe drought which reduced agricultural production and exports gave rise to a strong capital outflow and a depreciation of the peso which the authorities tried to counter through foreign exchange market intervention, higher official rates and, finally, the request for assistance from the International Monetary Fund (IMF).

The Spanish economy's exposure to these two economies through the trade channel is moderate, with the foreign investment and banking channels being more important (see Chart 8). Specifically, in 2017 Turkey was the eleventh export market for Spain (the fourth outside the EU) and Argentina was the 35th. Spanish goods exports to Turkey that year, mainly consisting of manufactured goods, accounted for 21% of the total (0.5% of GDP, slightly lower than the 0.6% relating to the EU) and grew at a slower pace than imports. Sales of goods to Argentina only accounted for 0.5% of Spain's total goods exports (0.1% of GDP), although they grew more than imports. As regards financial relationships, Turkey is the

19th most important market in direct investment, accounting for 1.2% of Spanish total assets abroad, concentrated in the banking and insurance sectors (40% and 12%, respectively, of the total). Argentina accounts for 2.6% of total direct investment assets abroad (ranking 12th), with predominance of the financial and telecommunications sectors.

During the early weeks of September, emerging markets overall tended to stabilise. Several central banks' responses, in the form of raising policy rates (Czech Republic, Indonesia, India and Philippines), intervention in the foreign exchange markets (India and Hong Kong) and a series of measures adopted by China to sustain short-term growth and stabilise the renminbi, contributed to calm the markets. The two countries most affected by the shocks have also adopted orthodox economic measures. Thus, Turkey's central bank raised interest rates significantly, to 24%, while Argentina's monetary authority increased the policy interest rate to 60%. The Argentine government also announced an important fiscal adjustment (seeking to obtain a balanced budget in 2019 and a primary surplus of 1% of GDP in 2020) and at the same time requested an advance on the disbursement of funds envisaged in the agreement entered into with the IMF.

In recent years China has made progress in reducing the imbalances in its economy. The readjustment has been significant (see Charts 1 and 2) as regards both expenditure (with a decline in the weight of investment, from accounting for 48% of GDP growth in 2011 to 35% in 2017, in favour of consumption) and branches of activity (with an increase in the weight of the services sector of more than 10 pp during that period, to 60% of GDP growth, at the expense of industry). China has also adopted a set of policies since 2016 to reduce its high level of debt. These measures, particularly those relating to shadow banking, have reduced aggregate credit growth and stabilised debt, mainly that acquired by non-financial corporations, as a percentage of GDP (see Charts 3 and 4).

However, this process is facing a series of difficulties in recent months, with economic activity performing less favourably both for internal reasons (partly owing to the deleveraging process itself) and for external ones (mounting trade tensions with the United States). Against this background, the Chinese authorities

seem to be opting for ensuring growth at short term, even at the expense of slowing down the correction of imbalances. This box describes the policy measures adopted recently and analyses their implications for the process of rebalancing China's economy.

The first clear sign of the new expansionary economic stance arose on the monetary front. At end-June, the People's Bank of China (PBoC) reduced the reserve ratio by 50 bp. It also adopted a more expansionary tone in press releases relating to liquidity management. As a result of these two measures, the interbank rate declined to around 2.8%. Other regulatory changes relating to financial institutions (with less restrictive guidelines on the management of financial assets and products) and the lending policy were also agreed, including: i) laxer collateral eligibility criteria for loan facilities in monetary policy transactions; ii) adjustment of macroprudential assessment parameters to encourage lending; and iii) greater incentives for the granting of loans to SMEs and to local government financing vehicles.

Chart 1
GDP GROWTH BY COMPONENT

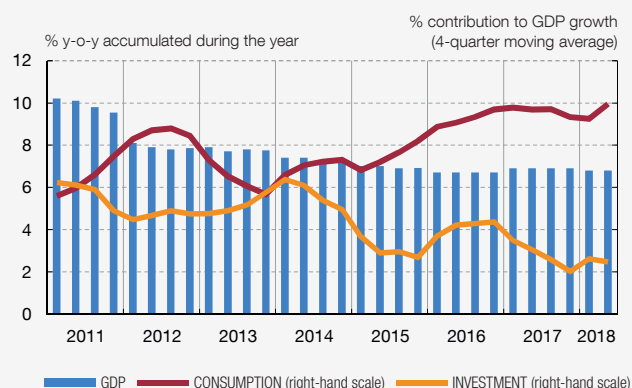


Chart 2
SECTORAL CONTRIBUTION TO GDP GROWTH

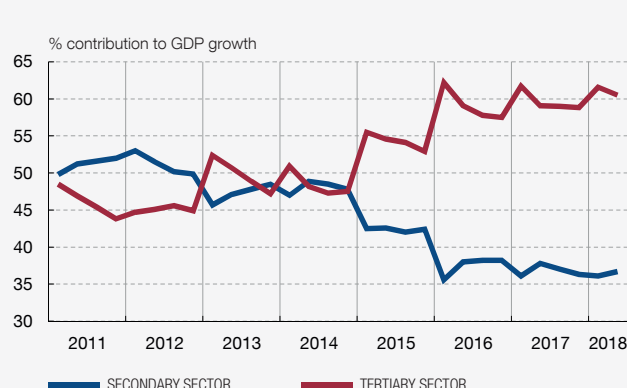


Chart 3
DEBT BY SECTOR

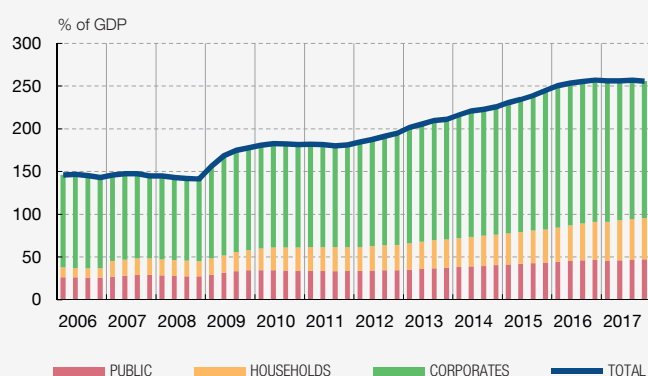
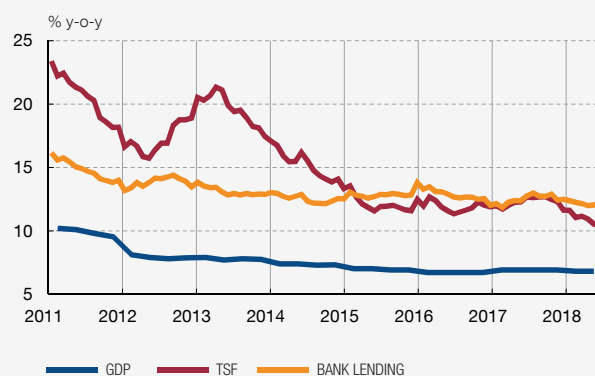


Chart 4
REAL GDP GROWTH, BANK LENDING AND TOTAL SOCIAL FINANCING



SOURCE: CEIC. Latest observation: 2018 Q2.

As regards the fiscal policy, at end-July the State Council revealed plans to cut taxes to firms (in part through the deduction on R&D expenses). This amounts to 0.1% of annual GDP and is additional to the decrease in taxes and levies for an amount equivalent to 1.3% of GDP (announced in March), including most notably a decrease in income tax amounting to 0.4% of GDP. Also until June 2018 China had issued only 30% of the annual quota for local government special bonds and had incurred only 30% of the fiscal deficit target, which suggests that there is ample margin for a proactive fiscal policy in the future. In this connection, the State Council also advised local governments to speed up the issuance of special bonds (amounting to 1.6% of GDP) and encouraged financial institutions to cover the funding needs of local government financing vehicles aiming to finance infrastructure investment spending.

Finally, the recent depreciation of the renminbi has ambiguous effects on economic activity. On the one hand, it may favour exports; but, on the other it may have adverse effects on investor confidence, generating capital outflows. In fact, since mid-June, the PBoC appeared not to be intervening in the foreign exchange markets and, accordingly, depreciation was driven by the market, owing to divergences in growth expectations between the United

States and China, the reduction in interest rate spreads and the escalating trade tensions between the two countries. However, in August the Chinese monetary authority apparently commenced to intervene in favour of the renminbi to anchor exchange rate expectations, reintroducing the so-called “counter-cyclical factor”¹ and raising the reserve requirement from 0% to 20% for foreign exchange transactions.

All of these measures, which were designed to stabilise growth in the near term, contribute to partially halt the process of reducing imbalances in the economy, which could increase the risks to growth in the medium and long term. Also, foreign exchange market intervention and capital flow controls could hamper the internationalisation of the renminbi and the full opening of the capital account. Nonetheless, it can be stated that their impact on the imbalances is, to date, very limited, although there is still no hard evidence that it has been possible to halt the deceleration of activity.

1 The “counter-cyclical factor”, which aims to moderate short/medium-term fluctuations in the renminbi's exchange rate, was introduced by the PBoC in May 2017.

After its strong performance in 2017, in the first half of 2018 economic activity in the euro area slowed faster than had been expected at the end of last year, mainly as a consequence of weak exports in the current context of tightening global financial conditions, heightened global uncertainty and rising protectionism.¹ Nevertheless, GDP across the euro area as a whole continued to grow faster than potential output (which various estimates situate at rates of around 1.5%), enabling the output gap to turn increasingly positive this year (see Chart 1), after narrowing in the final months of 2017. This output gap trend can be extrapolated to the individual euro area countries (albeit to differing degrees) except in the case of Italy, where growth remains weak and the output gap is still negative.

Compared with other cycles observed since the 1970s, the process of recovering pre-recession levels of output has been slower,² particularly in those countries most affected by the sovereign debt crisis, such as Italy and Spain. Moreover, the expansion observed since the trough in early 2013 has so far been shorter and growth weaker than the average for expansionary phases in other cycles, which seems to suggest that there is still scope for it to continue.³ Underlying this weak recovery is the sluggishness of all the GDP components, in particular exports and business investment (which only returned to pre-crisis levels for the euro area as a whole after a considerable delay, at the end of 2016) (see Chart 2).

By contrast, the current phase of the cycle is strong in terms of job creation, partly as a result of wage moderation and of the comparatively large contribution to growth from sectors more labour-intensive, such as services. In this context, the European Commission's business surveys point to a growing proportion of firms having difficulty finding labour (Chart 3). Also, levels of capacity utilisation have risen to historical highs in most countries. It is therefore worth asking to what extent supply side constraints are becoming increasingly binding.

Focusing on labour, since 2017, as noted above, there has been a significant increase across the euro area in the percentage of firms considering labour shortages to be a limiting factor on activity, in

manufacturing as well as services and construction.⁴ This trend is relatively widespread across countries, although particularly marked in Germany, France and the Netherlands. Additional evidence of the possible emergence of supply side constraints in some countries and sectors comes from the job vacancy rate, which has been on an upward path since the end of 2014, suggesting hiring has become more difficult. This trend has nevertheless been compatible with persistently high levels of unemployment in certain countries, suggesting there is a problem of a mismatch between the skills required by firms and those that the unemployed can offer. In this connection, Chart 4 shows how, from a historical perspective, there is currently a higher percentage of firms reporting difficulties finding labour for the same level of unemployment.

In contrast with these signs of high levels of labour utilisation, the way other indicators have evolved points to a certain degree of slack remaining in the labour market, which would explain why until now labour shortages has been compatible with modest wage growth in the euro area. In this regard, a high level of involuntary part-time employment is observed in most countries, meaning that there is a relatively high percentage of part-time workers who would like to work more hours (Chart 5).⁵ This phenomenon would help to explain why the number of hours per worker remains at historically low levels in many countries, despite the increase in employment in terms of the number of persons employed (Chart 6).

It is therefore difficult to determine precisely the strength of possible supply side restrictions and their potential impact on growth in activity in some countries in the area. Nevertheless, although the labour supply indicator shows rising shortages across the euro area as a whole, the increase is still small: just 20% of firms say they are concerned about labour shortages, less than the percentage pointing to insufficient demand as a limiting factor on activity. Furthermore, most firms consider there to be no factor limiting their activity at the moment (Chart 3), and this is so even in those countries with low unemployment rates, such as Germany. This all suggests that the degree to which supply-side constraints are increasingly binding is subject to strong heterogeneity between countries and industries, and possibly between individual firms.

Additionally, looking ahead, the role that the recent strong migratory inflows might play in alleviating possible labour market tightness in the euro area is unclear, given the current difficulty of estimating how employable these migrants are and their possible

1 For a detailed analysis of the factors that may be behind the slowdown in the area's GDP at the start of the year, see Box 2 "Has the slowdown in economic activity in the euro area been a result of permanent or temporary factors?", *Economic Bulletin* 2/2018, Quarterly report on the Spanish economy, Banco de España.

2 The different cycles are not fully comparable. For example, after a deep recession, the recovery tends to be slow, and the subsequent expansion, longer lasting.

3 Applying a methodology similar to that used in Box 2 of ECB *Economic Bulletin* 4/2018 suggests that, in the euro area, the average duration of the expansions was 31 quarters, compared with 19 quarters in the current expansion, while the average intensity was 20 pp in GDP terms (9 pp in the current phase).

4 In the third quarter of 2018, these percentages for the euro area as a whole were 16.7%, 19.2% and 20.6% in industry, services and construction, respectively.

5 In Germany and Italy, the percentage of involuntary part-time employment is fairly moderate, although the trend is heading in opposite directions: rising in Italy and decreasing in Germany.

(cont'd)

Chart 1
EURO AREA. GDP GROWTH AND OUTPUT GAP (a)

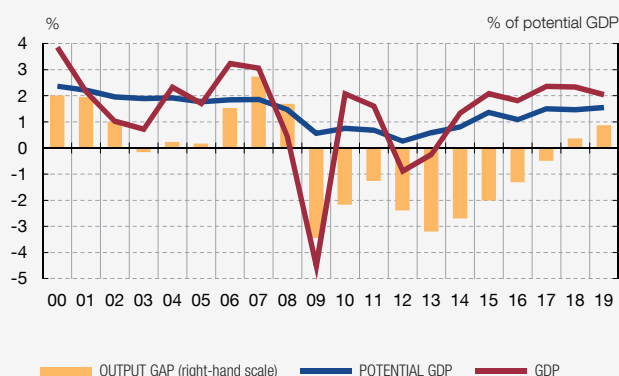


Chart 2
EURO AREA. ANNUAL AVERAGE GROWTH BETWEEN PEAKS IN THE CYCLE (b)

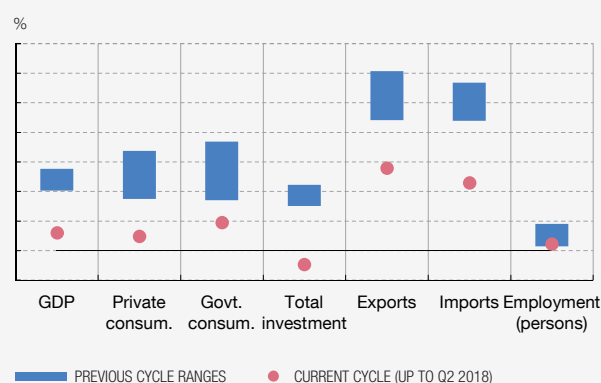


Chart 3
CAPACITY UTILISATION (EURO AREA AND COUNTRIES) AND FACTORS LIMITING ACTIVITY IN THE EURO AREA (c)

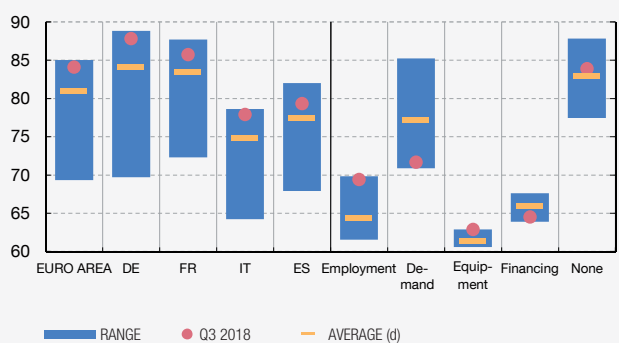


Chart 4
LABOUR SUPPLY SHORTAGES AND UNEMPLOYMENT RATE. EURO AREA COUNTRIES (2004-2018)

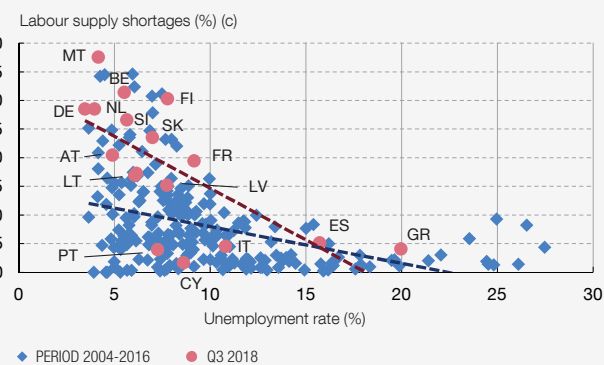


Chart 5
INVOLUNTARY PART-TIME EMPLOYMENT

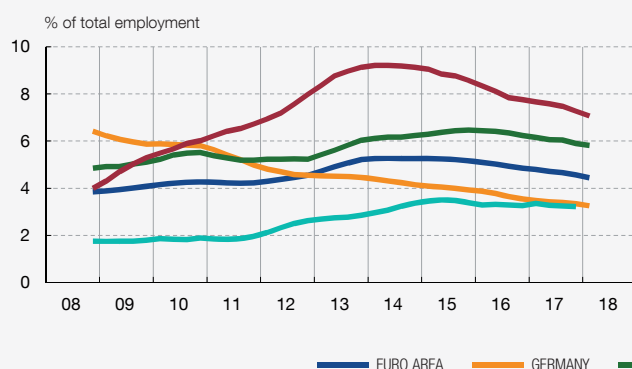
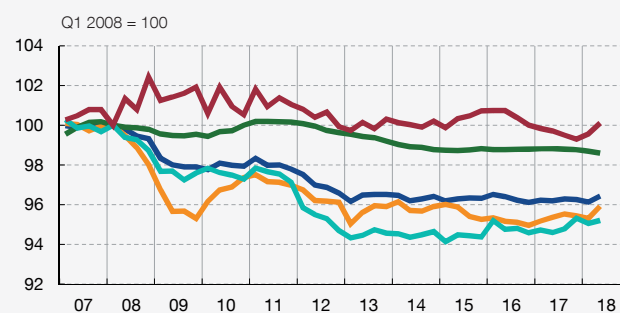


Chart 6
HOURS PER EMPLOYEE



SOURCE: European Commission.

a European Commission data (spring 2018).

b Cycles go from one peak to the next following the Centre for Economic Policy Research (CEPR) chronology. Specifically, the periods considered are: Q3 1974 to Q1 1980; Q1 1980 to Q2 1992; Q2 1992 to Q1 2008 and Q1 2008 to Q2 2018 (incomplete cycle).

c Average of factors limiting activity in services, industry and construction.

d Average since 1999 for capacity utilisation and since 2004 for factors limiting activity.

(cont'd)

difficulty in joining the labour force. Lastly, it is also unclear whether there is still room for the participation rate of certain population groups (such as women and young people) to rise in some countries, given that their values are still relatively low by international standards.

In short, the available evidence suggests that the possible supply side restrictions on some factors of production, particularly labour, in some sectors of certain core euro area economies are not sufficiently intense at present to explain the slowdown in the euro area economy in the first half of this year. By contrast, this

deceleration could be mainly reflecting demand factors relating to declining global demand for goods and services, and to adverse developments in agents' confidence, against the backdrop of growing geopolitical tensions. Looking ahead, however, if the euro area's growth proceeds according to current forecasts, which are consistent with growth at a pace exceeding its potential rate, supply side factors can be expected to start to play a progressively more significant role in shaping output growth. In turn, on the historical evidence, this should support a sustained rise in inflation rates towards levels compatible with the ECB's aim to maintain inflation rates below, but close to, 2% over the medium term.

The fluctuations in the saving rate of Spanish households since the onset of the crisis reflect how several factors, of variable strength and direction, have come together and influenced the consumption, saving and financing decisions of households in a particularly complex setting. In recent years, against a backdrop of subdued growth in household income, the saving rate in our country has fallen sharply to historically low levels. This decline has not been an isolated phenomenon in the euro area, where other countries have also shown a trend towards a lower level of saving (see Chart 1), especially those that were affected by a high degree of macrofinancial uncertainty during the crisis, such as Portugal and Ireland. This box reviews the available evidence on the decline in the household saving rate in recent years and its determinants.

At the start of the crisis, Spanish households had to make consumption, saving and financing decisions in a clearly adverse macroeconomic environment, characterised by a high degree of

uncertainty¹. In this context, the saving rate of households, as a percentage of their disposable income, rose by 7.5 percentage points (pp) between 2007 and 2009, to 13.4 % in 2009. Conversely, since 2010, this rate has fallen continuously and very sharply to below 6% of disposable income in 2017 (see Chart 2). Initially, the fall in the saving rate could be explained by factors such as the role of saving as a stabilising factor of the pattern of consumption over time which, in any event, diminished in aggregate terms, given the sharp decline in household income.

From 2014 on, however, household consumption began to increase, in a setting of strong recovery of employment. This upturn in the labour market led to a decrease in precautionary

1 See Ó. Arce, E. Prades and A. Urtasun (2013), "Changes in household saving and consumption in Spain during the crisis", *Economic Bulletin*, September, Banco de España.

Chart 1
CHANGES IN SAVING RATE BY COUNTRY

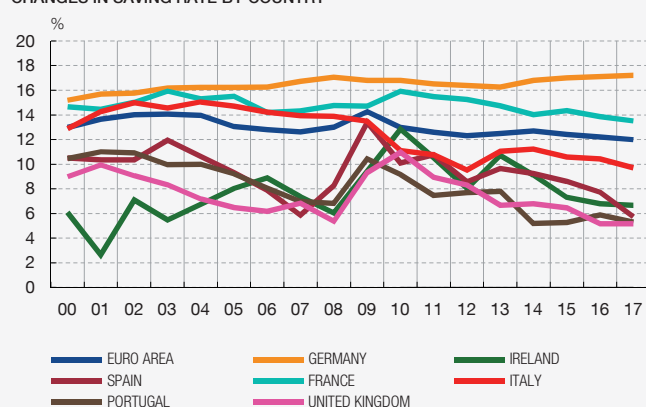


Chart 2
CONSUMPTION AND GROSS DISPOSABLE INCOME. Cumulative four-quarter data.

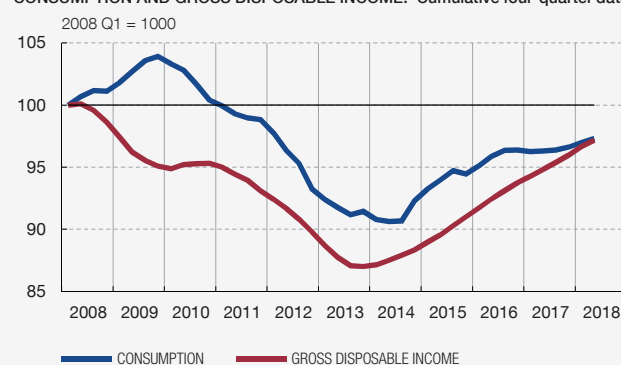


Chart 3
OBSERVED AND SIMULATED CONSUMPTION (a)

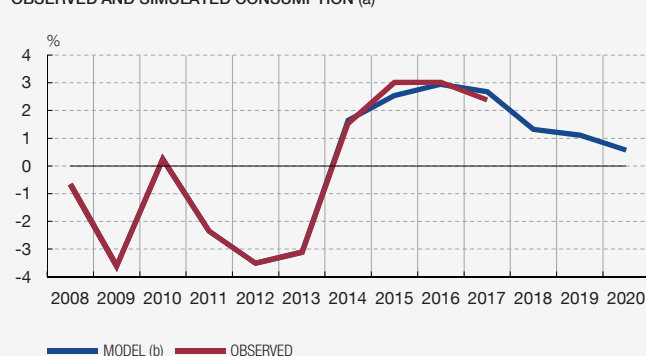
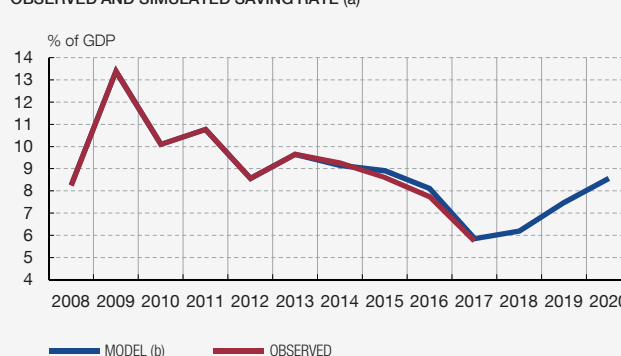


Chart 4
OBSERVED AND SIMULATED SAVING RATE (a)



SOURCES: INE, Eurostat and Banco de España.

a Projection dating from 2013 Q4. Observed income and wealth.

b Income, wealth, and financial conditions projections are the ones presented in this Economic Bulletin.

saving, given the improved prospects of obtaining and maintaining a job. In addition, the increase in employment income entailed a clear boost to consumption, but had less impact on saving, in view of the changes in the composition of the consumption basket desired by households following the constraints of the crisis. Specifically, households increased the weight of spending earmarked for the purchase of consumer durables, a type of spending that had contracted significantly during the recessionary period, since it was less essential and thus easier to cut back on and postpone². This led to a rebound effect on spending on such goods and services, which is estimated to have slowed the recovery of saving.

Lastly, it is worth mentioning that developments in lending are also estimated to have influenced the path of saving in the last decade. The sharp fall in the consumption of durable goods at the beginning of the crisis seems to have reflected, in addition to the aforementioned voluntary reduction in purchases of this type of goods, a worsening in the conditions of access to financing for Spanish households³. In view of the greater difficulties to obtain credit, the reliance of the consumption of goods on household income increased significantly, directly affecting the saving rate. In parallel, since the beginning of the crisis, the level of household indebtedness has undergone a significant correction, which, in the most recent period, has led to a reduction in the weight of debt servicing, enabling households to maintain their consumption levels, with a lower rate of saving.

In short, in recent years, a broad set of factors have contributed to maintaining a low saving rate, which has, in part, underpinned household consumption. However, in the coming years, the household saving rate can be expected to return to levels that are closer to historical averages, as some of these determinants lose momentum.

To illustrate this, Charts 3 and 4 show the dynamic forecasts⁴ obtained with the model⁵ for total consumption and household saving, beginning in 2014 Q1, and the changes actually observed in consumption and the saving rate. As the charts show, the path of the saving rate observed in the 2014-2017 period is fairly close to that envisaged by the model, which reflects the developments in its determining factors. Looking ahead, to the horizon for 2018 to 2020⁶, and in a scenario of a slowdown in household income growth, moderation of durable goods consumption and less favourable financial conditions, the saving rate can be expected to increase, according to this analysis.

2 See J. M. Gonzalez Mínguez and A. Urtasun (2015), "Consumption dynamics in Spain by product type", *Economic Bulletin*, September, Banco de España, and M. Martínez Matute and A. Urtasun (2017), "The recovery of private consumption in Spain by product type and household", *Economic Bulletin*, 2/2017, Banco de España.

3 See Box 7, "Recent developments in the consumer credit market in Spain", in this quarterly report.

4 Conditional on the observed paths of income, wealth and financial variables.

5 Results obtained using a VECM-type model, which includes the main determinants mentioned earlier. According to this model, consumption, employment income and wealth (financial and non-financial) are closely linked variables in the long term, that also interact in the short term, in which financing conditions are incorporated as an additional explanatory variable. The model contains equations for the consumption of durable and non-durable goods, employment income and non-financial wealth. See T. Sastre and J. L. Fernández-Sánchez (2005), "Un modelo empírico de las decisiones de gasto de las familias españolas", Working Papers, No. 0529, Banco de España, and T. Sastre and J. L. Fernández-Sánchez (2011), "La tasa de ahorro durante la crisis económica: el papel de las expectativas de desempleo y de la financiación", *Economic Bulletin*, November, Banco de España.

6 The projections for income, wealth and financial conditions are those presented in the updated [Macroeconomic projections for the Spanish economy \(2018-2020\)](#).

In the 2016-17 two-year period, inbound tourism flows were extremely buoyant both in nominal and real terms. Specifically, over 2017 as a whole, the arrivals of tourists in Spain and their spending grew by 8.7% and 12.4%, respectively. However, so far in 2018, tourism sector indicators have slowed notably with the result that in the first seven months of the year arrivals of foreign tourists and their spending only increased by 0.3% and 3%, respectively, compared with the same period of 2017. Furthermore, this pattern of deceleration has intensified in more recent months. Notably, in July, the numbers of inbound tourists declined by 4.9% in year-on-year terms. The possible continuation of the latest trends over the next few months could lead to 2018 being the first year since 2009 that growth in tourism in Spain is lower than that of GDP (see Chart 1). The remainder of this box seeks to analyse the explanatory factors of recent developments in the behaviour of inbound tourism in Spain.

The main driving factors of tourism inflows include changes in the economic activity of the source countries for tourism, as a whole, where the latter are weighted as part of the total, as a scale variable, together with other variables that measure changes in costs and in prices relative to their competitors. The course of competitiveness is approximated by the real effective exchange rate vis-à-vis developed countries, which is constructed with consumer prices as an – albeit imperfect – indicator of the relative developments in the cost of goods and services acquired by foreign tourists in Spain compared with the cost of the same consumption basket in alternative tourist destinations. Further, the trajectory of oil prices, insofar as it is the main determinant of transport costs, helps to explain the performance of non-resident tourism.

Nevertheless, the highly robust demand of non-resident tourism seen in 2016-17 cannot be explained solely by changes in its fundamentals. In fact, although the strengthening of growth in the developed economies contributed positively over this period, higher oil prices and the appreciation of the euro had the opposite effect (see Chart 3). A simple econometric model which approximates the performance of Quarterly National Accounts (QNA) real tourist receipts based on these explanatory factors shows how changes in the income of source countries for tourism would account for around 2 pp of the average growth in tourism services exports in the period 2016-17. This is estimated to have been largely offset by the combined, somewhat smaller, contribution of the opposite sign from competitiveness and oil price variables (see Chart 4). As can be seen, all of the factors not specifically included in the model made a very high contribution to growth in tourism in 2016-17. In particular, the perceived lack of safety and security prevailing in certain competitor regions was foreseeably an essential reason for the outstanding performance of tourism in 2016-17. In fact, as a result of the geopolitical situation in certain areas of the Mediterranean basin such as Turkey and North Africa, significant tourism flows were diverted to other countries such as Spain (for Turkey, see Chart 5).

In the first two quarters of 2018, the resumption of the upward path of oil prices and the appreciation of the euro in nominal

effective terms are estimated to have weighed on non-resident tourist arrivals through higher transport costs and the loss of competitiveness relative to non-euro area countries. This led to a slight widening of the negative contribution of these variables compared with the previous two-year period (see Chart 4). Furthermore, the positive contribution of the income in source countries decreased slightly which was linked to the slowdown in activity in the euro area (see Chart 2). However, as shown in Chart 4 the subdued buoyancy of tourism in the first half of 2018 would be explained, especially, by the decline in the positive contribution of other factors, due, notably, to the geopolitical situation in the above-mentioned competitor destinations gradually returning to normal. As indicated by Chart 6, fewer tourists were arriving in Spain from the main European source countries at the same time as tourist inflows to destinations such as Turkey, in particular, were recovering significantly. Specifically, in the first seven months of the year, arrivals in Spain of German, British and French tourists declined, in year-on-year terms, by 5.8%, 2.8% and 1.7%, respectively, in contrast to the arrivals in Turkey of tourists from each of these three countries which rose by 20.5%, 37% and 24.1%¹.

As mentioned earlier, inflows of foreign tourists slowed down slightly more sharply than average spending per tourist which seems to suggest that there is a small composition effect whereby the low-cost segment would have weakened relative to the higher-spending segments. This may reflect that the recovery of other Mediterranean destinations has been based on the lower-end of the tourist market. In any event, the trend towards higher growth in average spending per tourist has already been observed over the last decade, along with an increase in the relative weight of stays in high-end hotels compared with mid-low end hotels (see Chart 7). These signs of a slight shift towards higher quality tourism could be part of the hoteliers' response to the saturation of certain destinations on the coast and to some market innovations such as the emergence of the digital platforms of the sharing economy which compete for more-price sensitive tourist demand.

Tourism is very important in the Spanish economy and is a significant support for the external surplus. Specifically, although the slowdown seen this year has interrupted the recent rising trajectory, the share of tourism exports in GDP amounts, in nominal terms, to 4%, while the tourism services surplus has stabilised at 2.9% of GDP (see Chart 8). The importance of tourism, in a highly competitive environment, underlines the significance for the sector of ongoing adaptation to market trends geared, in particular, to improving the supply of high added-value services, in order to achieve a sustained increase in receipts per visitor. This is particularly needed in a setting where, as indicated above, the saturation of certain destinations is restricting the growth of the total number of visitors.

¹ In addition, it has been argued that certain temporary factors could be possible explanations for weak inbound tourism in Spain last summer, such as the world cup and the heat wave in large areas of central and northern Europe, which may have curbed last minute reservations.

Chart 1
ACTIVITY IN THE TOURISM SECTOR



Chart 2
INBOUND TOURISM GDP

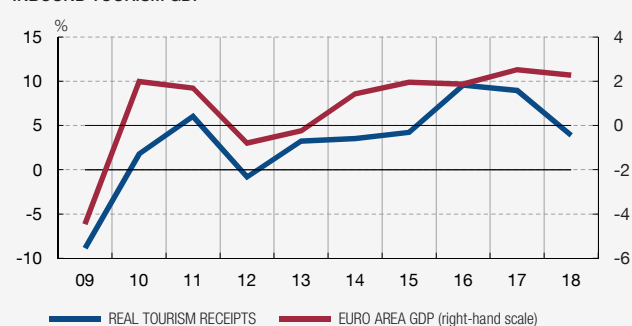


Chart 3
EXCHANGE RATE AND OIL PRICES

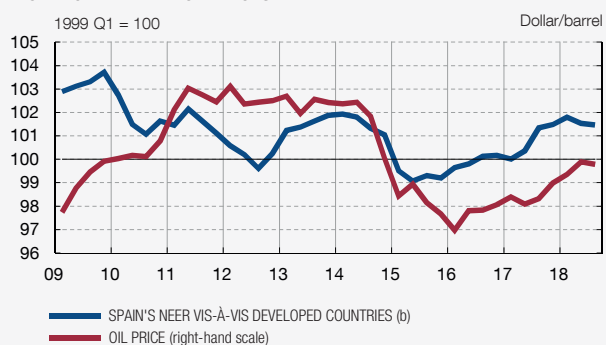


Chart 4
REAL EXPORTS OF TOURIST SERVICES

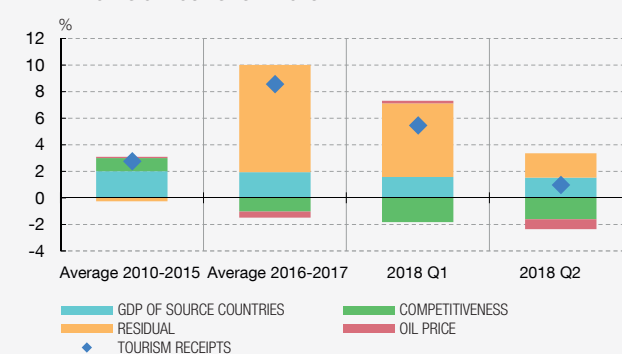


Chart 5
INTERNATIONAL TOURIST ARRIVALS

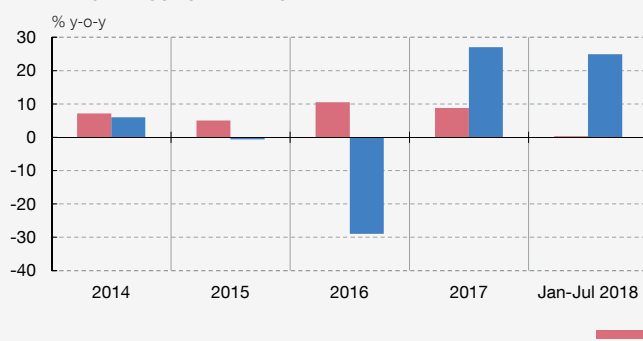


Chart 6
INTERNATIONAL TOURIST ARRIVALS TO SPAIN AND TURKEY BY COUNTRY

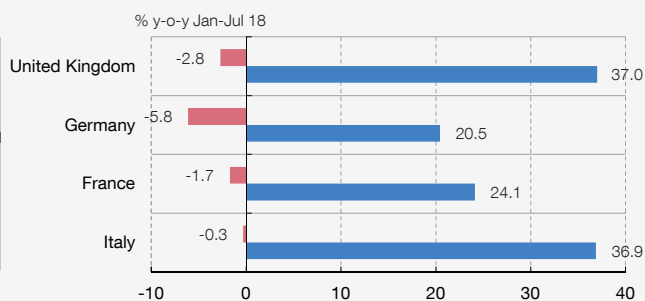
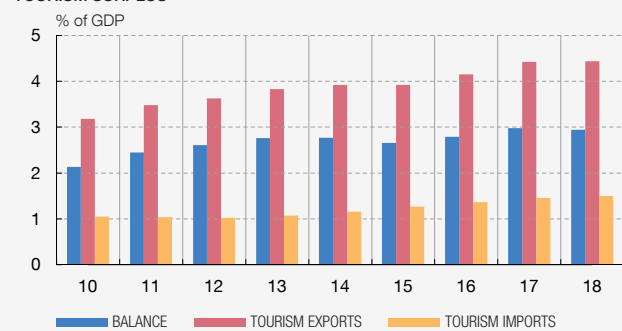


Chart 7
INTERNATIONAL TOURISTS BY HOTEL TYPE



Chart 8
TOURISM SURPLUS



SOURCES: INE, Exceltur, Central Bank of Turkey, Eurostat and WTO.

- a Composite indicator of Spanish tourism GDP and Spanish GDP, compiled by Exceltur.
b An increase in the index denotes a loss of competitiveness and vice versa.
c High-end refers to 4 and 5 star hotels. Mid-low end refers to all other lower category hotels and hostels and guest houses.

Since 2014, total outstanding consumer credit has followed a path of sustained recovery; by mid-2018 its year-on-year growth rate stood at around 14% (a rate that rises to 21% in the case of credit for consumer durables), and the cumulative increase since the end of 2014 has been 47%. This contrasts with the behaviour of other segments of lending to households, in particular, credit for house purchase, the amount of which is currently still contracting, although at an increasingly moderate rate (see Chart 1). The different behaviour of consumer credit is explained by the larger increase in lending activity in this segment in the recent period, as reflected in the fact that the volume of new lending has doubled since 2014 (see Chart 2), and also by the shorter maturities of this type of loan, in comparison with lending for house purchase, which means that the outstanding amounts react more rapidly to changes in activity.

As seen in Chart 3, unlike in the cyclical upturn before the last crisis, the current recovery in consumer credit is being driven by lending to finance spending on durables. In particular, as Chart 4 shows, the dynamics of spending on durables since the beginning of the crisis can largely be explained by the behaviour of sales of cars for private use (approximated by the path of new car registrations).¹

Charts 3 and 4 show that the behaviour of spending on durables and of lending to finance such spending is clearly cyclical. During the crisis, when economic expectations were sharply deteriorating, the contraction in these two aggregates was very intense, while, since the beginning of the recovery, they have both grown strongly. Chart 5 shows that, in comparison with spending on durables, this pro-cyclical behaviour is even more pronounced in the case of lending to finance such spending. Accordingly, the proportion of durable consumption financed out of future income is also cyclical, as is also reflected in the moderation of the household saving rate over the last few years (see Box 5 of this report).

The evidence available in the Bank Lending Survey, presented in Chart 6, suggests that the recent recovery in activity in the

consumer credit market has been driven by the rise in both the supply of and the demand for funds. Both have increased, according to this source, at higher rates than those seen in the market for loans for house purchase. According to the banks that responded to the survey, the main reason for the expansion in supply was the increase in competition. This has occurred against a background of low margins and reference interest rates, with the spread between the rates on new consumer credit and credit for house purchase remaining relatively steady at around 6 pp (18 pp in the case of credit card credit, which continues to represent less than 10% of total consumer credit).²

Following the recent developments in consumer credit, the outstanding amount stood in mid-2018, in real terms per household, at close to its 2004 levels, although it was still well below the previous cyclical peak (32% below the level recorded in 2008 Q1, see Chart 1). At the same time, the above-mentioned evidence also suggests that financing for car purchases has also gained weight during the current upturn.

To sum up, the data analysed in this box show that the consumer credit market has contributed to the economic recovery in recent years, mainly by financing the increase in the consumption of durable goods and, in particular, that linked to the acquisition of vehicles. However, as highlighted by the last crisis, rapid increases in lending can entail risks for future financial and macroeconomic stability, by raising agents' vulnerability to adverse shocks. In the latest case, although these developments have been compatible with a pattern of deleveraging by households and consumer credit continues to have a low weight in financial institutions' total lending (around 5%), it should also be taken into account that the absence of collateral in this type of lending, except in the case of loans for car purchase, raises the risk for such institutions. To minimise these risks it is important that the decisions of lenders and borrowers that lie behind the dynamism of the consumer credit market be based on prudent expectations regarding the ability to repay this debt.

¹ This is in contrast to the years leading up to 2008, when the increase in spending on durables was determined to a greater extent by the increase in spending on household appliances associated with the expanding property market.

² Although the recent expansion in the supply of consumer credit according to the BLS seems, by historical standards, to be moderate, it should be borne in mind that this type of survey tends to underestimate movements involving an easing of supply conditions.

Chart 1
TOTAL OUTSTANDING CREDIT TO HOUSEHOLDS (a)

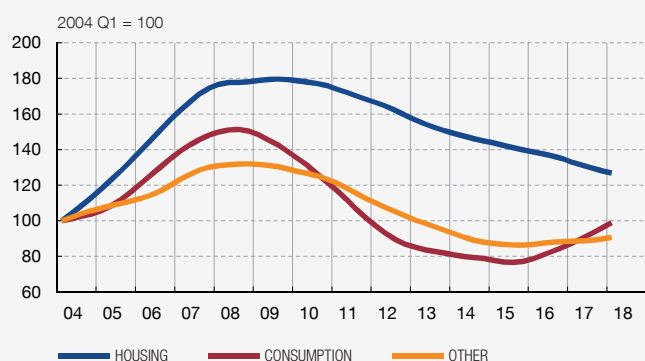


Chart 2
NEW LENDING TO HOUSEHOLDS (a) (b)

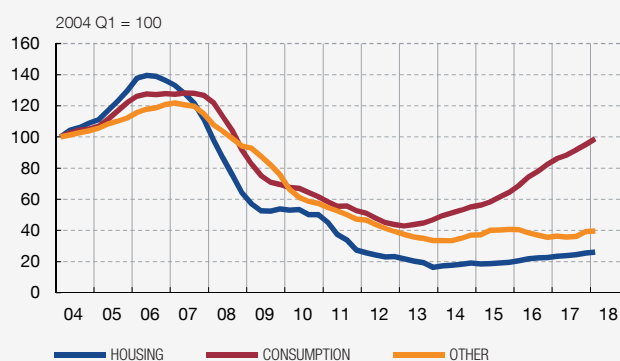


Chart 3
TOTAL OUTSTANDING CONSUMER CREDIT BY PURPOSE (a)

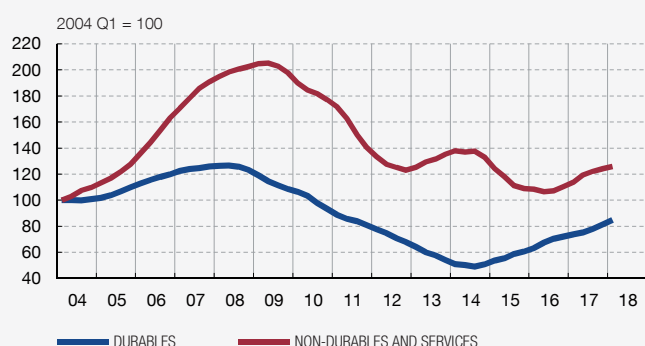


Chart 4
CONSUMPTION EXPENDITURE AND GROSS DISPOSABLE INCOME (a)

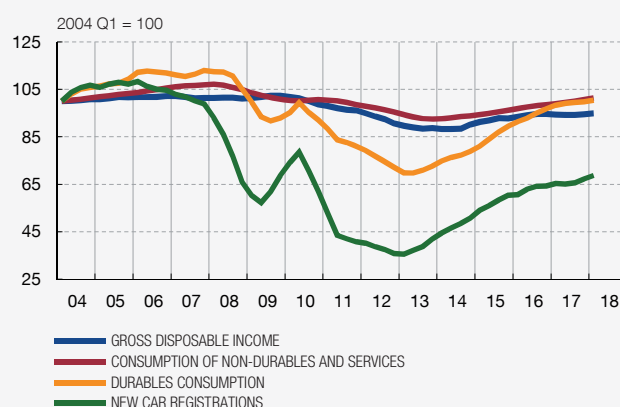


Chart 5
FINANCING OF CONSUMPTION EXPENDITURE (a)

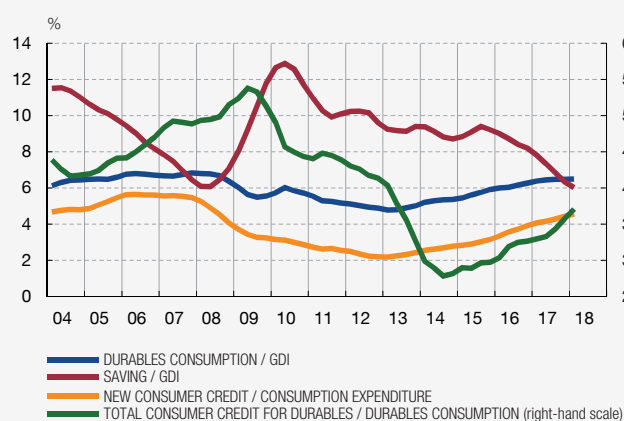
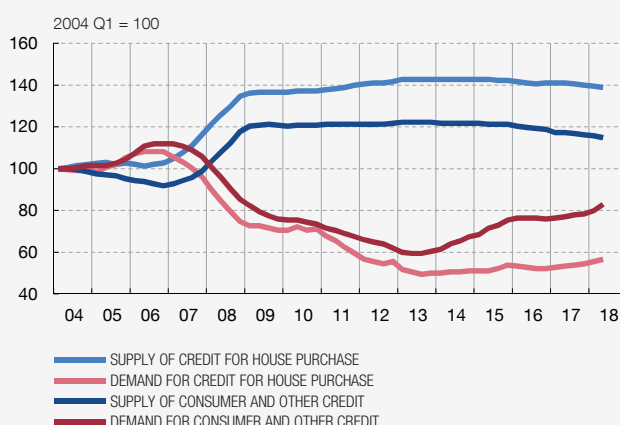


Chart 6
CREDIT SUPPLY AND DEMAND INDICATORS (c)



SOURCE: Banco de España.

- a Series in real terms, at the household level. Moving average of the current and three preceding quarters.
- b The series for new consumer credit and other lending are adjusted to take into account the statistical break in June 2010, when the way in which credit card transactions are reported changed. From December 2014, the series are net of renegotiations.
- c Series calculated by means of accumulation of the diffusion index (InD) created on the basis of the Bank Lending Survey (BLS). An increase in the series indicates greater restrictions (supply) and greater demand for credit (demand). The indicator at each moment in time is constructed as a weighted average of the responses of the banks. (a) Supply: $1 \times (\% \text{ of banks that have tightened their standards considerably}) + 0.5 \times (\% \text{ of banks that have tightened them somewhat}) - 0.5 \times (\% \text{ of banks that have eased their standards somewhat}) - 1 \times (\% \text{ of banks that have eased their standards considerably})$. (b) Demand: $1 \times (\% \text{ of banks reporting a considerable increase}) + 0.5 \times (\% \text{ of banks reporting some increase}) - 0.5 \times (\% \text{ of banks reporting some decrease}) - 1 \times (\% \text{ of banks reporting a considerable decrease})$.

2 THE EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

2.1 The external environment of the euro area

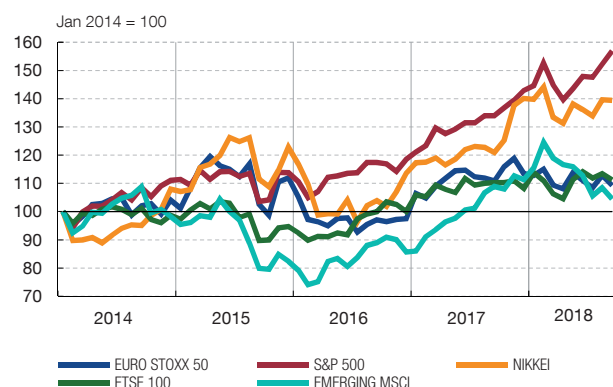
In 2018 Q2, global activity remained buoyant, since the recovery in growth among the advanced economies, especially in the United States, offset the slowdown recorded in certain emerging economies. The high-frequency indicators suggest that the rate of growth of activity will be sustained in Q3, and will moderate somewhat thereafter. In fact, the short-term risks to this path of sustained growth are tilted to the downside, given the uncertainty regarding global trade relations and the fact that the US macroeconomic policy mix may generate further financial strains in emerging markets.

The behaviour of the international financial markets was also mixed. While in the United States the tone was very positive, other developed markets performed less favourably and emerging economy markets suffered a significant deterioration. US stock markets reached all-time highs, driven by the favourable macroeconomic data and corporate earnings, and by the repatriation of capital by firms as a result of the tax reform. By contrast, euro area and UK markets saw moderate losses, due to trade tensions and the lack of agreement on Brexit. The gradual normalisation of monetary policy in the United States and the strong appreciation of the dollar against most currencies, especially those of emerging economies, have had a significant impact on the financial conditions of the economies with the greatest vulnerabilities. Despite the weakening of most of the emerging currencies (with the exception of the Mexican peso), stock market falls, the widening of sovereign debt spreads and capital outflows, this turbulence seems to be contained for the time being and in markets with better fundamentals the recent deterioration is being corrected (see Box 2). Finally, trade tensions arising from the protectionist measures taken by the United States particularly affected the markets in China, leading the authorities to take a number of steps to curb the depreciation of the renminbi and the potential slowdown in activity (see Box 3).

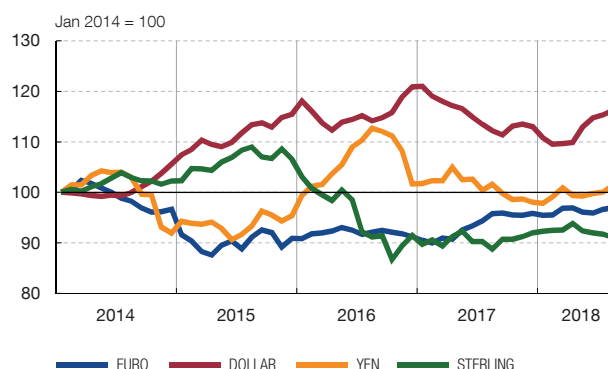
The commodities price index declined by 4.1% in the last quarter, owing to the widespread decrease in the price of its components, which was particularly pronounced in the case of industrial metals, against a backdrop of downside risks for international economic activity and, especially, for emerging economies. The price of Brent increased by 2.9% in the quarter and is trading at above \$75. The sharp fall in Venezuela's output, US sanctions on Iran and the lower-than-expected increase in Saudi Arabia's output, following the June agreement between OPEC and its partners to increase supply, seem to have offset the factors depressing world demand.

In the United States GDP growth was very high in Q2 (rising from 2.2% to 4.2%, in annualised quarter-on-quarter terms) spurred by the recently approved tax package. In Japan, GDP quickened in Q2 (from 0.2% to 0.5% quarter-on-quarter) moving unexpectedly upwards, driven by private consumption, and in the United Kingdom GDP rose 0.2 pp to 0.4% quarter-on-quarter, underpinned by a slight recovery of consumption. Energy prices pushed inflation rates higher. In the United States, the year-on-year headline inflation rate reached 2.7% in August, and year-on-year core inflation stood at 2.2%. In Japan, consumer price growth remained stable (at 0.8% year-on-year in July, but below 1.4% at the beginning of the year), despite the record rise in nominal wages in June due to the payment of bonuses and overtime. In the United Kingdom, although inflation recovered slightly to 2.5% in July, it remains below

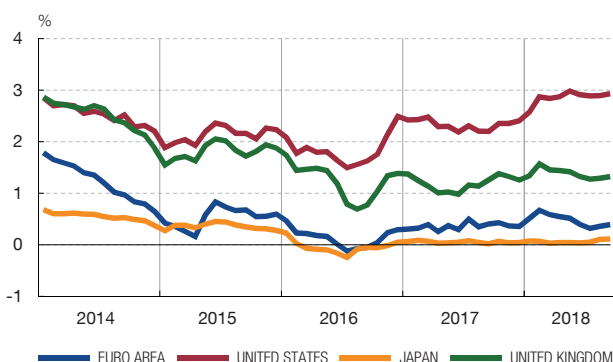
1 STOCK EXCHANGE INDICES



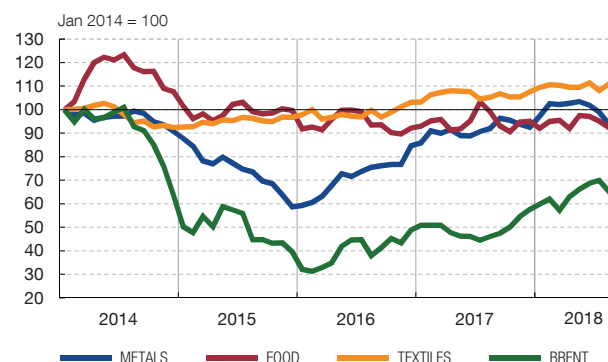
2 CPI-BASED REAL EFFECTIVE EXCHANGE RATES VIS-À-VIS DEVELOPED COUNTRIES (a)



3 LONG-TERM INTEREST RATES (b)



4 COMMODITIES

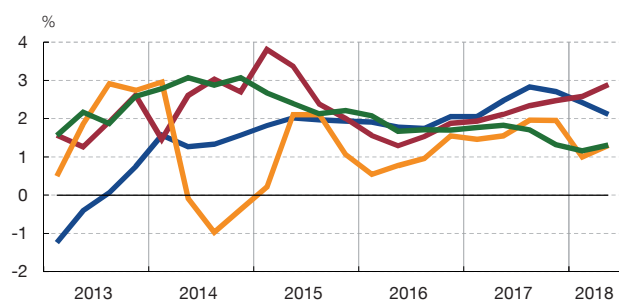
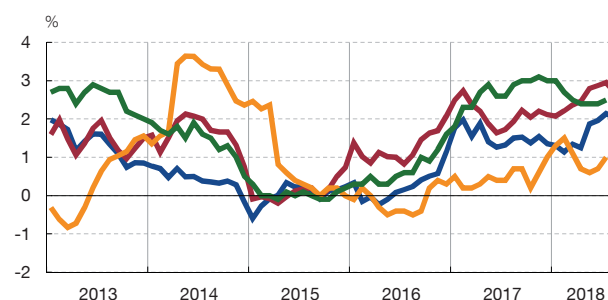


SOURCES: Datastream and Banco de España.

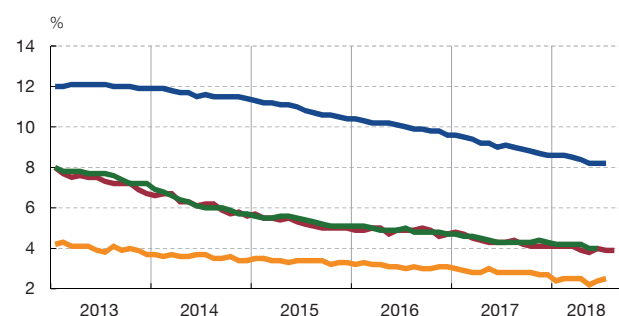
- a An increase in the index denotes an appreciation of the currency.
 b Ten-year government debt yields.

the level of 3% seen early in the year. Against this background, the Federal Reserve strengthened its communication about the path of future rate rises, increasing the discrepancy with market expectations. In July, for the first time since September 2016, the Bank of Japan changed its monetary policy framework, confirming its commitment to an ultra-loose monetary policy and introducing greater flexibility to its purchase programme. In August, the Bank of England raised the interest rate by 25 bp to 0.75%.

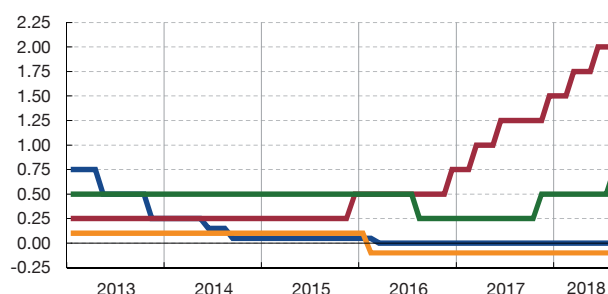
In the emerging economies, activity in 2018 Q2 generally performed less favourably. In Asia, GDP growth in China eased somewhat from 6.8% to 6.7% year-on-year, following a slowdown of investment resulting from policy tightening and the escalation of the trade war between the United States and China. In Latin America, activity data for 2018 Q2 showed considerable difficulties in the region, especially in Argentina. Finally, growth rates remained high in eastern Europe (except in the Czech Republic). As regards prices, the increase in inflationary pressures in Asian economies and eastern Europe stood out, while in Latin America inflation remained low (except in Argentina). Monetary policies experienced few changes, the main exception being those countries which were affected most by the recent turmoil in exchange markets (Argentina and Turkey), where policy interest rates were raised.

1 GROSS DOMESTIC PRODUCT
Year-on-year rate2 INFLATION
Year-on-year rate

3 UNEMPLOYMENT RATE (a)



4 POLICY INTEREST RATES



— EURO AREA — UNITED STATES — JAPAN — UNITED KINGDOM

SOURCES: Datastream and Banco de España.

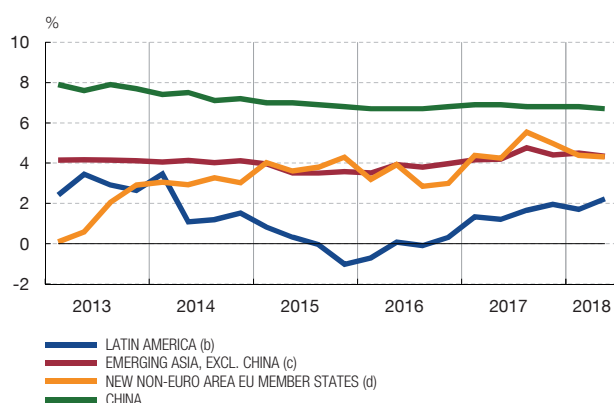
a Percentage of labour force.

2.2 The euro area and the monetary policy of the European Central Bank

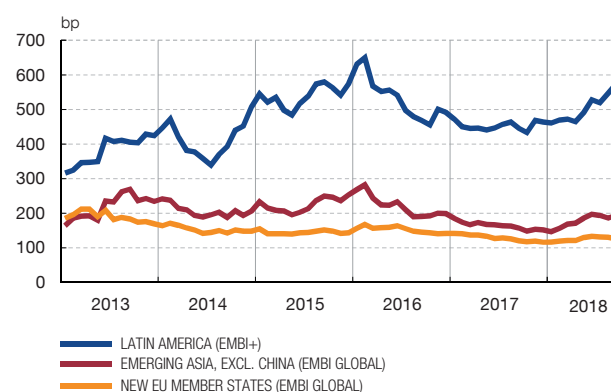
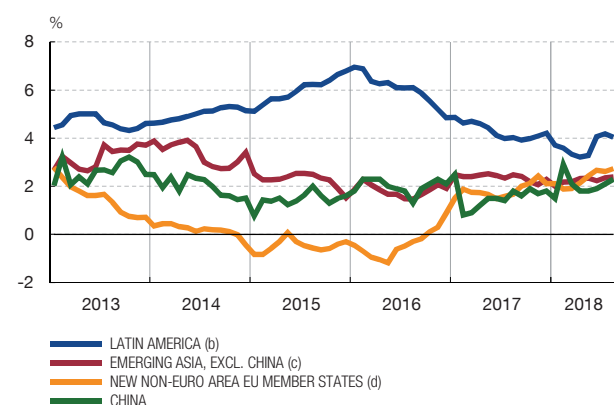
ECONOMIC DEVELOPMENTS

Economic activity in the euro area continued to expand in recent months, albeit at a notably lower pace than in 2017. The sustained appreciation of the euro against a broad set of currencies and the slowdown of world trade, in a setting of protectionist tensions, the deceleration in China and the materialisation of vulnerabilities in certain emerging markets, led to sluggish exports. Internal demand, by contrast, continued to expand, underpinned by favourable financial conditions, buoyant employment and lower deleveraging needs in the private sector. Nevertheless, in recent months, the confidence of consumers and business has deteriorated somewhat which could prompt their spending plans to be delayed or cancelled. Additionally, in Italy financial strains linked to uncertainty about the direction of the coalition government's economic policy have resurfaced, which has given rise to a worsening of the growth outlook for this economy.

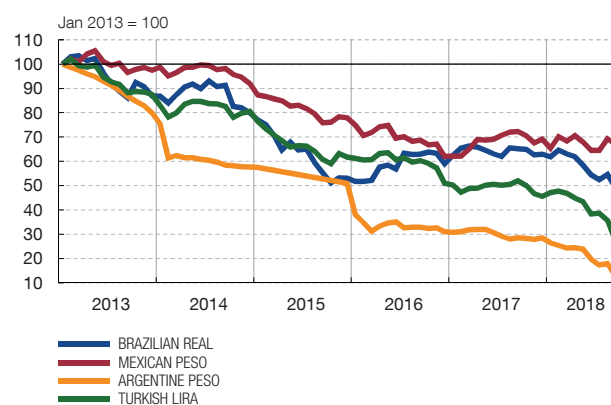
Thus, on national accounts figures, euro area GDP grew by 0.4% in 2018 Q2, the same rate as in the preceding quarter (see Table 2), which was considerably lower than rates of close to 0.7% posted a year earlier. The year-on-year growth rate reached 2.1% in Q2, down from 2.4% in Q1. In terms of components, quarter-on-quarter output growth was underpinned by gross fixed capital formation, both private and public consumption, and the contribution of inventories (0.1 pp) which in certain countries reached high levels (0.4 pp in Germany). The contribution recorded by net external demand was negative (-0.2 pp), the same as in the previous quarter, since the growth of imports outstripped that of exports. In the main euro area countries growth was markedly stable. Thus, the growth

1 GROSS DOMESTIC PRODUCT
Year-on-year rate

2 INTEREST RATE SPREADS OVER THE DOLLAR (e)

3 CONSUMER PRICES
Year-on-year change

4 EXCHANGE RATES AGAINST THE DOLLAR (f)



SOURCES: Datastream, Banco de España, IMF and JP Morgan.

a The aggregate of the different areas has been calculated using the weight of the countries in these areas in the world economy, drawing on IMF data.

b Brazil, Chile, Colombia, Mexico and Peru.

c Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.

d Poland, Hungary, Czech Republic, Bulgaria, Romania and, from July 2013, Croatia.

e JP Morgan EMBI spreads. Latin America includes Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. Asia includes China, Indonesia, Iraq, Kazakhstan, Malaysia, Pakistan, Philippines, Sri Lanka and Vietnam. The data on the new EU Member States relate to Hungary, Poland, Romania and, from July 2013, Croatia.

f A decrease in the index denotes a depreciation of the currency against the dollar.

rate rose by 0.1 pp in Germany to 0.5%, it slowed by the same amount in Italy and Spain to 0.2% and 0.6%, respectively, and it held at 0.2% in France. Employment in the euro area remained notably strong, increasing in Q2 by 0.4%, the same rate as in Q1.

The conjunctural information available for Q3 generally suggests that the moderate rate of increase – similar to that in the first half of the year – will continue (see Chart 5). The business confidence indicators based on the surveys of Purchasing Managers (PMI) declined in July and August for both the industrial and services sector, while those compiled by the European Commission (EC) fell in industry and increased slightly in services and construction. Similarly, the latest data on consumer confidence and employment expectations worsened in that period. As regards external demand, the assessment of export orders declined in July and August, and export expectations deteriorated in Q3. The quantitative indicators available, with more lagged information,

	2016	2017				2018		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
National Accounts (quarter-on-quarter rate)								
Gross domestic product	0.8	0.7	0.7	0.7	0.7	0.4	0.4	
Contributions to q-o-q change in GDP (pp)								
Internal demand, excluding inventories	0.7	0.1	0.7	0.3	0.5	0.3	0.4	
Change in inventories	0.2	-0.1	-0.1	0.1	-0.2	0.2	0.1	
Net external demand	-0.1	0.6	0.1	0.4	0.5	-0.2	-0.2	
Other indicators								
Unemployment rate (b)	9.7	9.5	9.2	9.0	8.7	8.6	8.3	8.2
HICP (y-o-y rate) (c)	1.1	1.5	1.3	1.5	1.4	1.3	2.0	2.0
CPI excl. energy and unprocessed food (y-o-y rate) (c)	0.9	0.8	1.2	1.3	1.1	1.3	1.2	1.2

SOURCES: Eurostat, ECB and Banco de España.

a Information available up to 19 September 2018.

b Average for the quarter. Latest available figure: July 2018.

c End of period. Latest available figure: August 2018.

EURO AREA GDP AND HICP GROWTH PROJECTIONS

TABLE 3

	2018		2019		2020	
	GDP	HICP	GDP	HICP	GDP	HICP
European Central Bank (September 2018)	2.0	1.7	1.8	1.7	1.7	1.7
European Commission (May 2018)	2.3	1.5	2.0	1.6	—	—
OECD (September 2018)	2.0	—	1.9	—	—	—
International Monetary Fund (July 2018)	2.2	—	1.9	—	—	—
Consensus Forecast (September 2018)	2.1	1.7	1.8	1.6	—	—
Eurobarometer (September 2018)	2.1	1.7	1.8	1.6	—	—

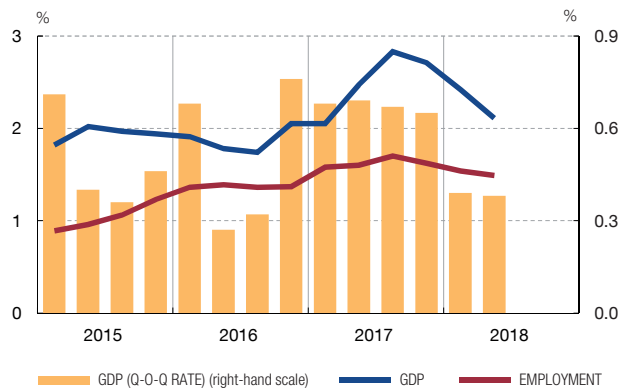
SOURCES: ECB, European Commission, Consensus Forecast, IMF, MJ Economics and OECD.

generally provide disappointing results for Q3. Specifically, retail sales decreased in July (0.2%) and, on the supply side, the industrial output index fell by 0.8% in July with respect to the previous month and the unemployment rate held at 8.2% for the third consecutive month. In contrast, vehicle registrations grew by 19.6% in August.

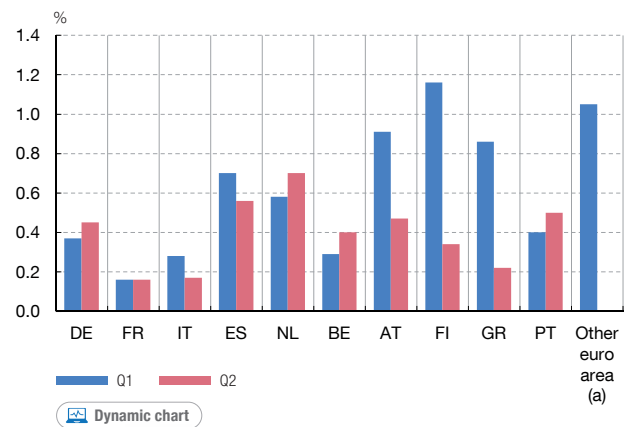
Further to the moderation of short-term growth, the deterioration of the situation of emerging economies, geopolitical tensions and uncertainty about protectionist policies are shaping a slightly less favourable scenario than was expected some months ago. Along these lines, in its September projection exercise, the ECB cut its GDP growth projections for 2018 and 2019 by 0.1 pp to 2% and 1.8%, respectively, and left the forecast for 2020 unchanged at 1.7% (see Table 3). The progressive waning of the monetary policy impulse along with, to a certain extent, the limitations on productive capacity arising from the expected decline in the working-age population justify this slowing profile (see Box 4). That said, the growth of euro area GDP is expected to continue to hold at above potential in the medium-term horizon.

Turning to prices, inflation was generally stable in recent months. The headline index grew 2% year-on-year in August, down 0.1 pp on the previous month, owing to the

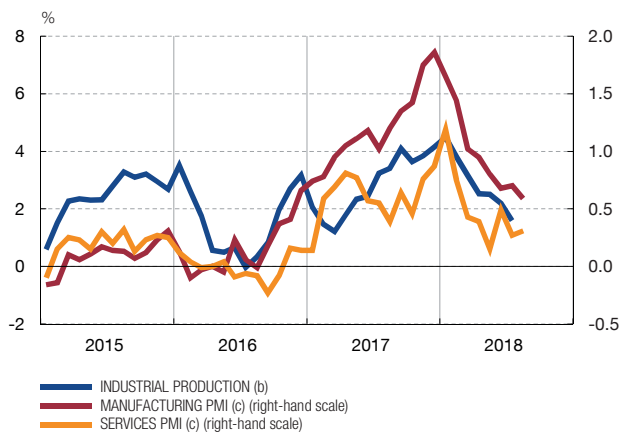
1 OUTPUT AND EMPLOYMENT
Year-on-year rate



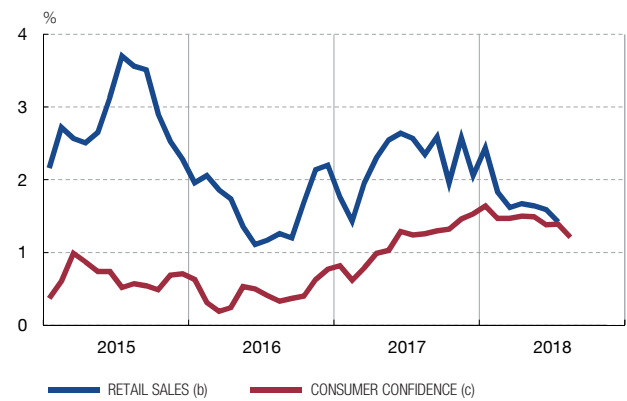
2 GDP BY COUNTRY
Quarter-on-quarter rate



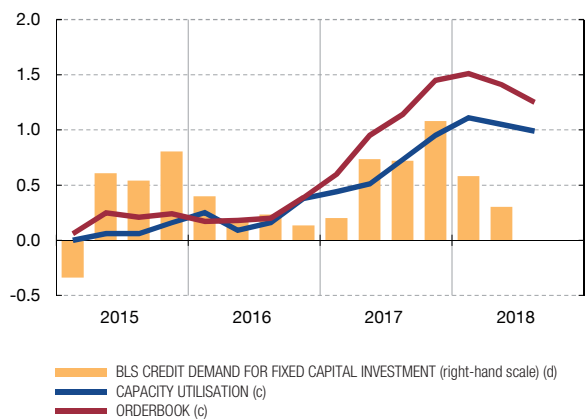
3 INDUSTRIAL ACTIVITY AND SERVICES INDICATORS



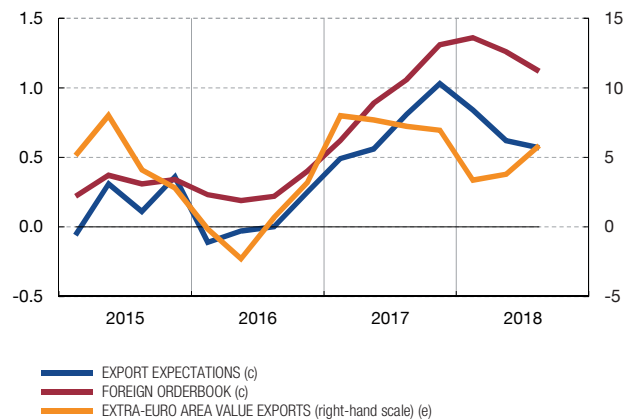
4 CONSUMPTION INDICATORS



5 INVESTMENT INDICATORS



6 EXPORT INDICATORS



SOURCES: Eurostat, Markit Economics and Banco de España.

a Excluding Ireland, owing to the high volatility of its data.

b Year-on year rates, calculated on the basis of the non-centred quarterly moving average of the seasonally adjusted series.

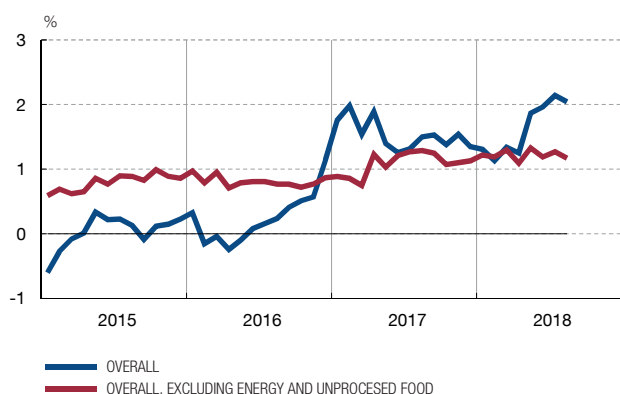
c Normalised series for the period represented.

d Bank Lending Survey. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase $\times 0.5$ - percentage of banks reporting some decrease $\times 0.5$ - percentage of banks reporting a considerable decrease. A positive value denotes an increase.

e Year-on-year rates of the original monthly series. Quarterly average.



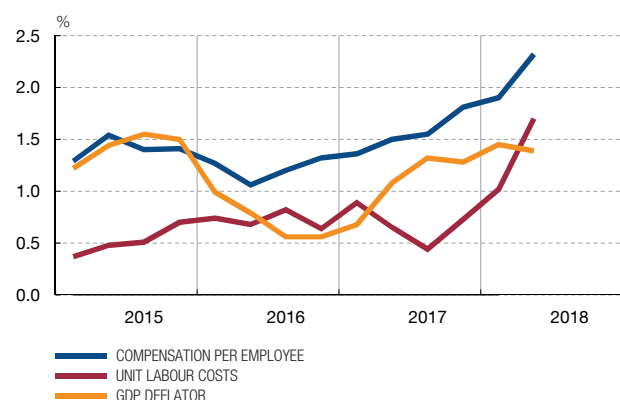
1 HARMONISED INDICES OF CONSUMER PRICES



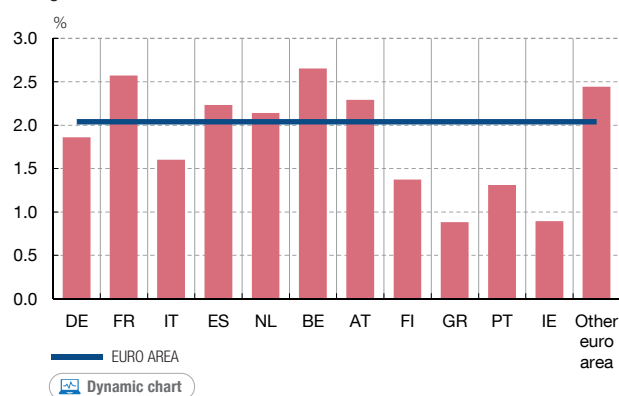
2 INFLATION EXPECTATIONS



3 WAGES AND COSTS



4 HEADLINE HICP
August 2018



SOURCES: Eurostat, Reuters and ECB.

a Implied inflation calculated on the basis of inflation swaps.

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deceleration of all of its components except for the prices of processed food whose growth rate remained unchanged. Core inflation, as measured by the CPI excluding unprocessed food and energy, also decreased by 0.1 pp to 1.2%, while other measures which remove the more volatile components held stable at rates of close to 1%. Conversely, negotiated wage rates rose notably compared to the restraint seen in previous years. In this setting, in the ECB's projection exercise, expected inflation for 2018-20 was maintained at 1.7% and core inflation was revised downwards by 0.1 pp in 2019 and in 2020 – to 1.5% and 1.8%, respectively – in view of the diminished strength of economic growth.

In the fiscal realm, the general government deficit is expected to continue to narrow in 2018 as a result of low interest rates and continued growth of activity. Fiscal policy's contribution to growth is slightly expansionary owing to a reduction in taxes and social security contributions in certain economies. Noteworthy, by country, is the situation of Italy where the agreement to form a government included a set of expansionary measures (minimum wage scheme and income tax cuts). These measures could contravene commitments acquired under the Stability and Growth Pact and might not be finally implemented. The budgetary plans which countries must submit to the EC by 15 October will contribute to dispelling the uncertainties.

Also, in the area of European governance, the Euro Summit of end-June approved the creation of a common backstop for the Single Resolution Fund whose final design will be agreed in December. This backstop will be created on the basis of a new credit line from the European Stability Mechanism (ESM) to replace the direct recapitalisation instrument, thus conserving the fiscal neutrality of its actions. Negotiations on other essential items such as the cyclical stabilisation mechanism and the common deposit guarantee system were postponed. The Eurogroup committed to continue to work on these matters. The Ecofin meeting in September discussed proposals made by the EC, within the framework of the negotiation of the European budget for 2021-27, to reallocate resources to support structural reforms and to establish a mechanism that contributes to sustaining public investment in crisis situations.

FINANCIAL DEVELOPMENTS AND MONETARY POLICY

In Q3, financial conditions in the euro area worsened, as a result of the appreciation of the nominal effective exchange rate of the euro against the currencies of emerging market economies, particularly the Turkish lira, and more recently against the dollar. The decline in stock prices for most of the quarter, which was more pronounced in banking institutions with higher exposure to Turkey and Argentina, and the increase in sovereign bond yields, also contributed to this deterioration (see Chart 7).

The upward trend in yields on securities traded on sovereign bond markets was widespread across countries, although it can be described as moderate in all cases except for Italy, where the start of the negotiations of the 2019 budgets in early August triggered another bout of tension, with strong upward pressures on the interest rates on government bonds and a decline in stock prices. At the beginning of September, the announcement by the Italian government that it would strengthen its commitment to comply with the requirements of the European fiscal framework led to a correction of yields, but there was still a great deal of uncertainty about the design of this economy's fiscal policy. This time, there were few signs of contagion to other sovereign yields, with the exception of Greek debt, which was more vulnerable to episodes of instability following conclusion of the assistance programme in August.

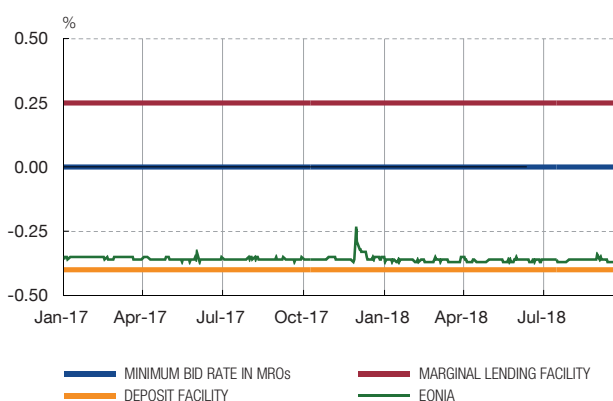
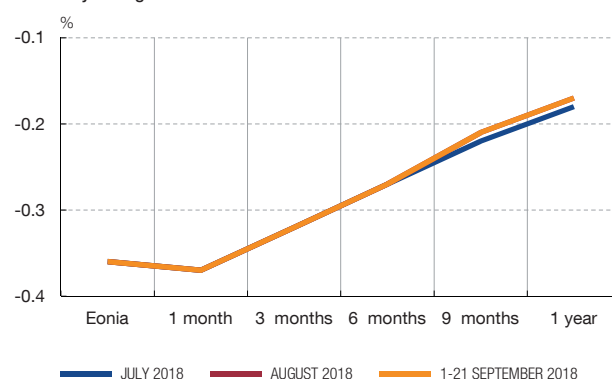
In Germany, the ten-year bond yield stood at 0.47% towards the end of September and the spread over US government debt held steady at around 263 bp, slightly above the level recorded at end-June.

In the stock markets, the Eurostoxx 50 index increased by 1% over the quarter as a whole, with an overall decline of 2.1% since the beginning of the year, in contrast with the climbing stock markets in the United States. The stock prices in the banking sector moved on a downward path from end-July that only changed course in September, with an overall increase of 0.9% in the quarter.

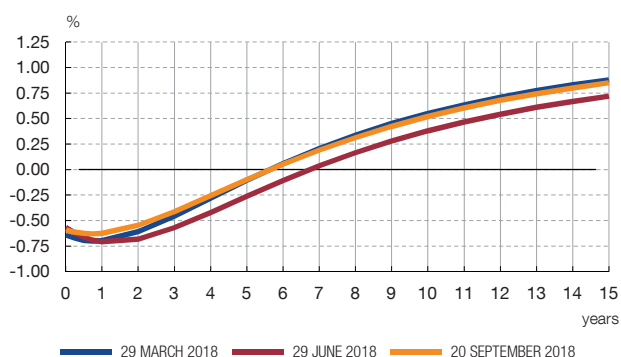
On the currency market, the most notable aspect was the appreciation of the nominal effective exchange rate of the euro, by 2.6% in Q3, following the rise of only 0.3% in the previous quarter (see Chart 7.6). By currency, the euro appreciated against sterling by 0.9% and the US dollar by 0.9%. There was a strong appreciation of the euro against emerging economies' currencies (38.5% against the Turkish lira, 37.4% against the Argentine peso and the South African rand, and 4.3% against the Chinese yuan).

Lastly, the rate of expansion of lending to non-financial corporations and households was maintained in July, with the year-on-year rates of change standing at 4.1% and 3%, respectively (see Chart 8). The Bank Lending Survey in the euro area for 2018 Q2 suggests that loan growth continued to be sustained by increasing demand across all loan categories

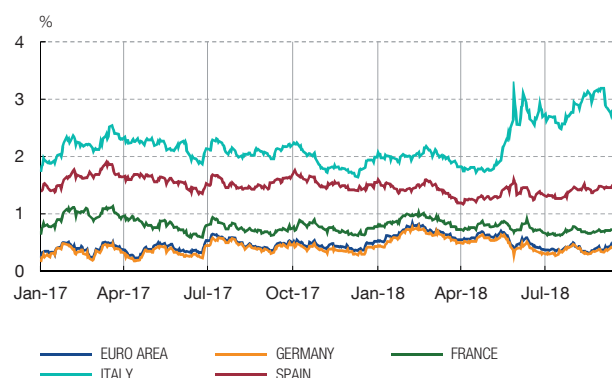
1 EONIA AND ECB INTEREST RATES

2 INTERBANK MARKET
Monthly average

3 ZERO COUPON CURVE (a)



4 TEN-YEAR GOVERNMENT DEBT YIELDS



5 EURO STOXX 50 INDEX AND IMPLIED VOLATILITY



6 NOMINAL EURO EXCHANGE RATE

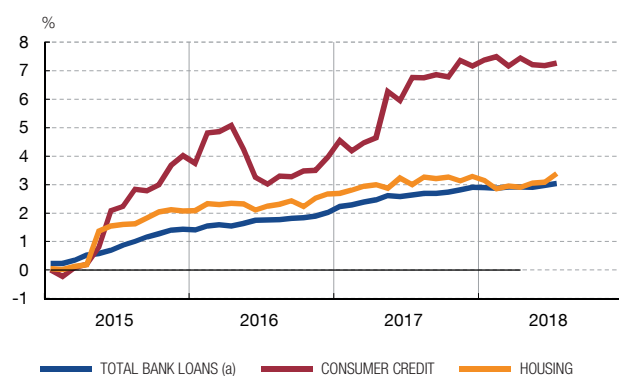
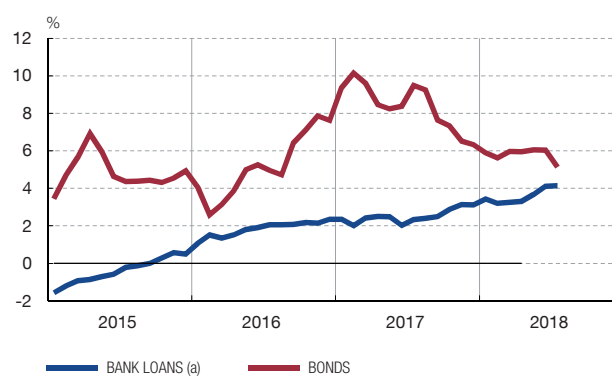


SOURCES: ECB and Banco de España.

a Estimated by the ECB using swap market data.

and slight moves to ease lending standards. As regards monetary aggregates, the year-on-year rate of M3 decreased by 0.5 pp in July to 4%. The year-on-year rate of the narrowest aggregate (M1) fell by 0.6 pp to 6.9%.

The slowdown in growth observed since the beginning of the year and the worsening of financial conditions underline the need to preserve the current monetary stimulus, in order

1 HOUSEHOLDS
Year-on-year change2 NON-FINANCIAL CORPORATIONS
Year-on-year change

SOURCE: ECB.

a Adjusted for securitisation and other transfers.



to ensure that inflation converges with the medium-term target, once the net asset purchases have concluded, as the ECB announced at its June meeting. Against this backdrop, at its September meeting, the ECB Governing Council reiterated that it expected to terminate net asset purchases in the framework of the APP at the end of the year, provided that the medium-term inflation outlook were maintained. In addition, the Council does not envisage changes in the short term to policy interest rates, which it expects to remain at their current levels¹ at least until the summer of 2019. Specifically, as regards the APP, the pace of net asset purchases will be reduced in October from the current €30 billion a month to €15 billion until December 2018, and will conclude in January 2019. Moreover, the Council intends to continue reinvesting the principal payments from maturing securities as they arise in its APP portfolio over a prolonged period once the net asset purchases have concluded and, in any event, for as long as necessary. With the APP having been in place for more than three years, the value of the portfolio acquired until August amounted to slightly more than €2.5 trillion (around 23% of euro area GDP) and reinvestments from September 2018 to August 2019 are expected to amount to more than €183 billion.

¹ The interest rates on the main refinancing operations, the marginal lending facility and the deposit facility stood at 0%, 0.25% and -0.40% respectively.

3 THE SPANISH ECONOMY

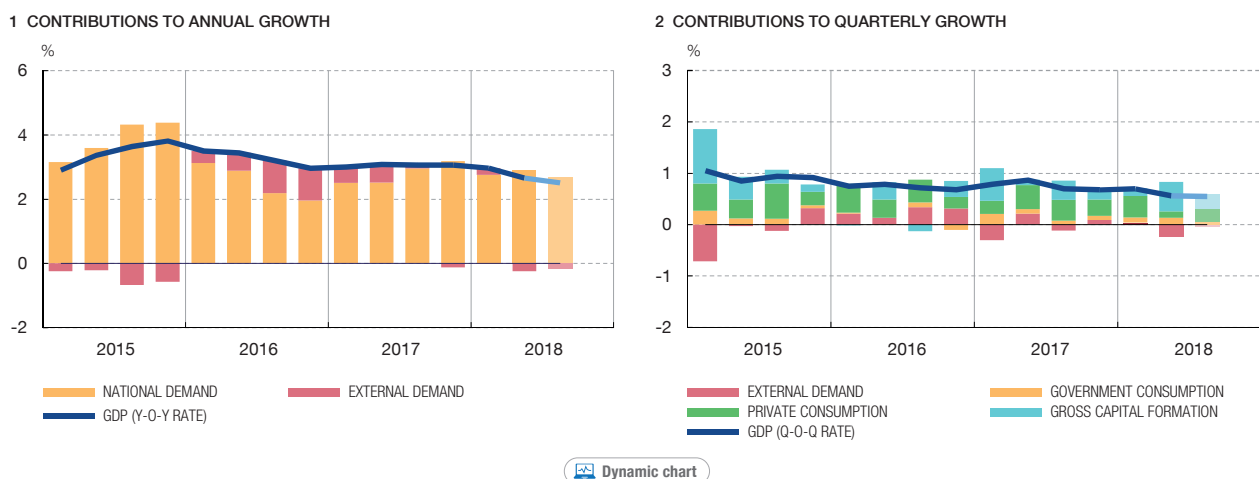
The quarter-on-quarter growth rate of the Spanish economy's GDP stood at 0.6% in 2018 Q2, 0.1 pp less than that recorded in the previous quarter (see Chart 9). The increase in output in the April-June period was exclusively attributable to the growth of domestic demand, whose positive contribution increased by 0.2 pp to 0.8 pp. Household spending (both on private consumption and residential investment) slowed down, while the remaining components of domestic demand accelerated (investment in capital goods and other products and in other construction, and government consumption). Conversely, the contribution of net external demand decreased to -0.2 pp, turning negative. Exports declined slightly more than imports, following increases in both in 2018 Q1. In year-on-year terms, the GDP growth rate moderated by 0.3 pp to 2.7% and the employment rate fell back 0.1 pp to 2.5%.

The conjunctural information available suggests that the pace of GDP growth will hold at 0.6% in Q3, as in the previous quarter. Domestic demand is estimated to continue to be the chief mainstay of output growth, whereas the contribution from external demand, on which there is still limited information, appears to remain slightly negative. Employment seems to have decelerated somewhat.

Since May, consumer prices have accelerated slightly because of the stronger growth of the energy component. Core inflation has moderated since then, as a result of the deceleration of the prices of services. Consequently, the year-on-year rate of change in the harmonised index of consumer prices (HICP) stood at 2.2% in August, 0.1 pp higher than in May, while core inflation (that which excludes energy and food) fell to 0.9 %, compared with 1.2% in May.

In the time lapsed since the beginning of 2018 Q3, the benchmark index for Spanish stock markets, the IBEX-35, fell by 0.3%, compared with an increase of 1% recorded for the same period by the EURO STOXX 50 of the euro area (see Chart 10.1). The performance of listed stock prices of Spanish firms with greater exposure to Argentina and Turkey was comparatively less favourable, particularly in the case of banks and, to a lesser degree, non-financial corporations. The risk premia on fixed-income securities issued by corporations have also risen, but in a subdued and isolated manner, standing below their end-June levels at the cut-off date for this report. The tensions in the Italian sovereign debt markets barely affected Spanish government debt. Thus, the Spanish ten-year bond yield has increased by close to 20 bp since the end of Q2, standing at 1.5%, while its German counterpart rose by approximately 15 bp, slightly widening the spread between them to 106 bp. On the interbank market, 12-month EURIBOR hardly changed and stood at -0.17%.

In recent months, financing conditions for households and non-financial corporations have remained very favourable, with the average cost of bank lending to the non-financial private sector holding at reduced levels, close to their all-time lows. This context has been conducive to the continued growth of new lending volumes, which has been stronger in the household financing segment, specifically in consumer loans. In terms of outstanding balances, these credit flow patterns have led to a slight easing of the rate of decline of loans to non-financial corporations, while the pace of growth of loans extended to households has been back in positive territory since June, for the first time since 2010.



SOURCES: INE and Banco de España.

a Seasonally adjusted series.



This appears to have been basically the result of the lower repayment volumes in the segment of loans for house purchase. Finally, the financial position of households and non-financial corporations seems to have continued to strengthen in Q2, thus continuing the trend observed in recent years.

3.1 Household spending decisions

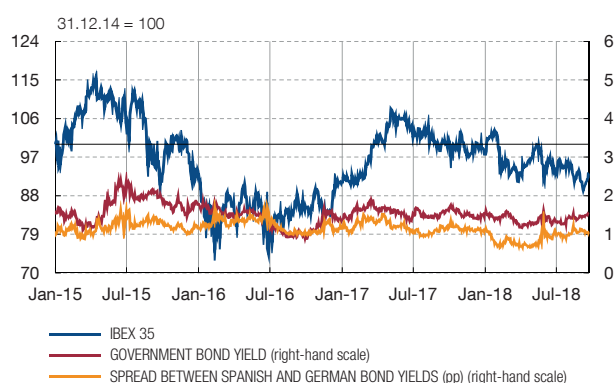
On the conjectural information available, the quarter-on-quarter rate of change in household consumer spending is estimated to have stood at 0.4% in Q3, a slightly higher rate of increase than that of the previous quarter, but notably lower than in the previous quarters (see Chart 11). The quantitative indicators published since the last Report offer mixed signals. The retail trade index quickened somewhat, as did the industrial production index (IPI) related with consumer goods. However, Social Security registrations performed less favourably than in previous quarters. The qualitative indicators, such as the services and consumer goods manufacturing PMIs or the retail trade confidence index, have tended to be less resilient than in Q2.

As regards residential investment, the latest economic data indicate that the rate of growth was higher in Q3 than in Q2. In particular, the coincident housing transaction indicators are especially buoyant. On INE data, prices of open-market housing accelerated in Q2, up to a year-on-year rate of growth of 6.8%, 0.6 pp above the Q1 figure. This higher increase in house prices occurred in the second-hand home segment, while the rate of growth of prices in the new-build segment was unchanged.

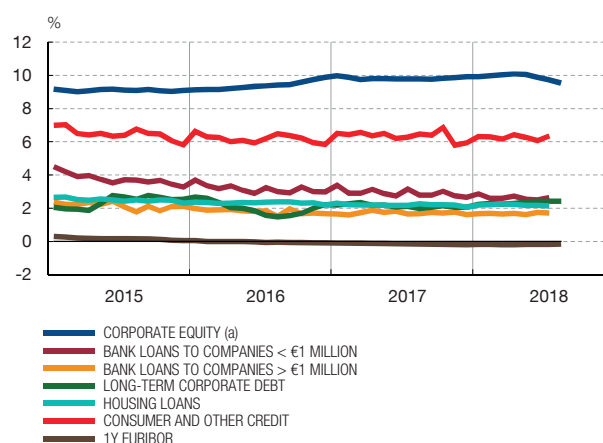
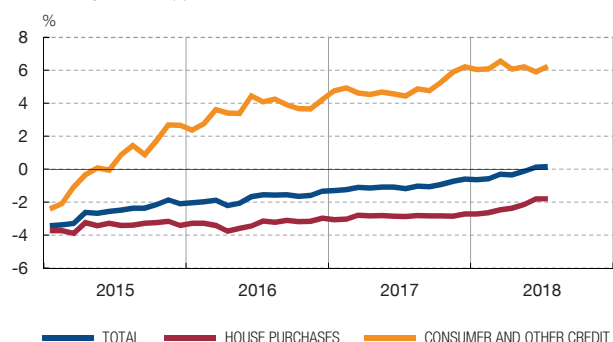
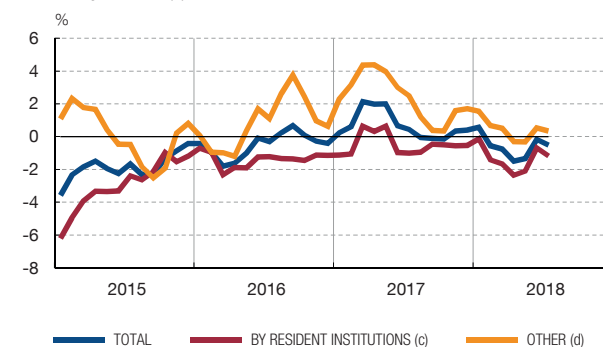
Households' borrowing costs have remained relatively flat, at low levels, in recent months. Thus, between March and July (the latest data available), the average interest rate applied to new loans for house purchase fell by 0.1 pp to 2.1% (very close to the all-time low recorded in December 2017), while the average interest rate on consumer and other credit held steady around 6.3% (see Chart 10.2).

The results of the latest edition of the BLS (corresponding to July) indicate that the supply of credit to households remained favourable in Q2, since banks again eased their lending standards for both segments (house purchase, and consumption and other purposes).

1 EQUITY AND 10-YEAR GOVERNMENT BOND MARKETS



2 COST OF FINANCING

3 LENDING TO HOUSEHOLDS
Year-on-year rates (b)4 FINANCING OF COMPANIES
Year-on-year rates (b)

SOURCES: Reuters, Datastream, MSCI, INE and Banco de España.

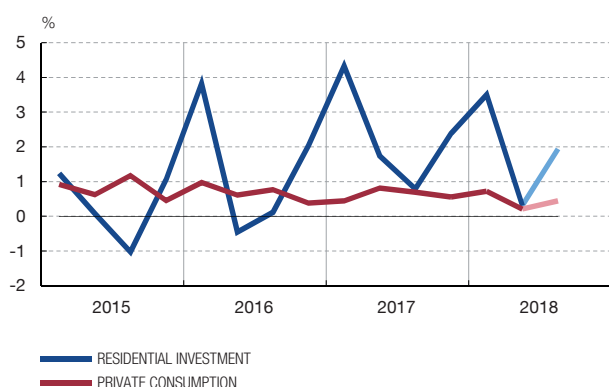
- a The cost of equity is based on a three-stage Gordon dividend discount model.
 b Includes off-balance-sheet securitisation and loans transferred to Sareb.
 c Loans from resident credit institutions and specialised lending institutions.
 d Includes loans from non-residents and financing through issuance of debt securities (including by resident subsidiaries).

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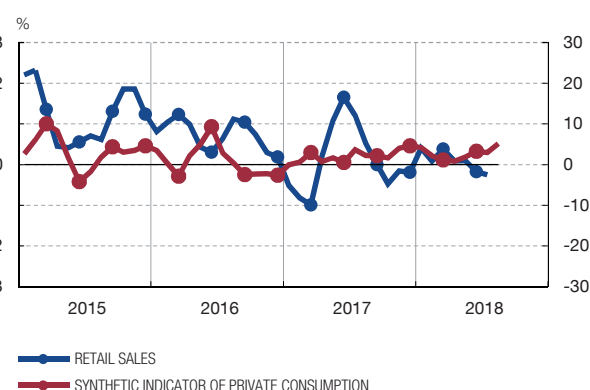
Likewise, the general conditions applied to loans granted to households eased once more, especially margins on average loans, most notably in the consumption and other purposes segment. In turn, according to the BLS, the demand for consumer and other credit rose sharply, posting an increase not observed since 2015 Q2, while in the house purchase segment demand rose more moderately. The BLS also shows that as a result of these changes in lending standards, and the higher solvency of applicants, the percentage of rejected loan applications fell again in Q2. For Q3 the banks expected increases in households' loan applications, as the supply of credit to households continued to ease.

This favourable combination of supply and demand factors translated into greater dynamism in the volume of new lending to households, with the highest rate of growth in the consumer credit and other purposes segment, driven in particular by the increase in new lending for durable goods consumption, whose rate of growth is outpacing that of consumer spending on durable goods (see Box 7). In terms of outstanding balances, the year-on-year rate of growth of households' bank debt has been in positive territory since June (0.2% in July, compared with the drop of 0.3% recorded in March), for the first time

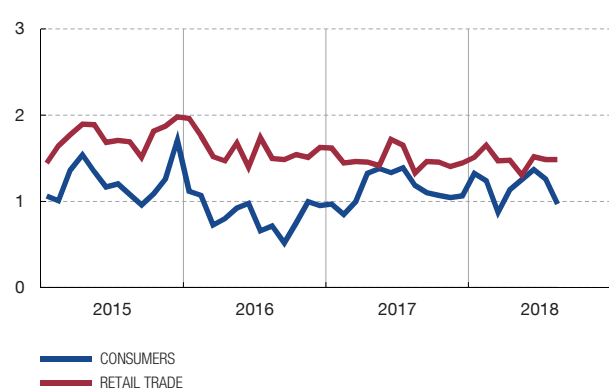
1 HOUSEHOLD SPENDING (QNA) (a)



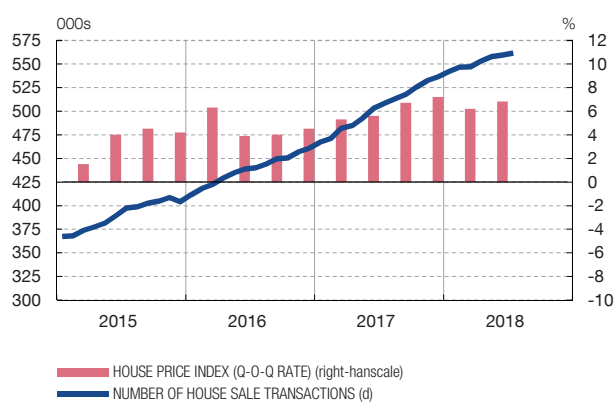
2 CONSUMPTION INDICATORS (b)



3 CONFIDENCE INDICATORS (c)



4 HOUSE PRICES AND TOTAL TRANSACTIONS



SOURCES: INE, European Commission, ANFAC, Centro de Información Estadística del Notariado and Banco de España.

a Quarter-on-quarter rates calculated using seasonally adjusted series.

b Rates of change of moving average of three terms with three time lags, calculated using the seasonally adjusted series. The dots represent quarter-on-quarter rates.

c Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

d 12-month moving sum.

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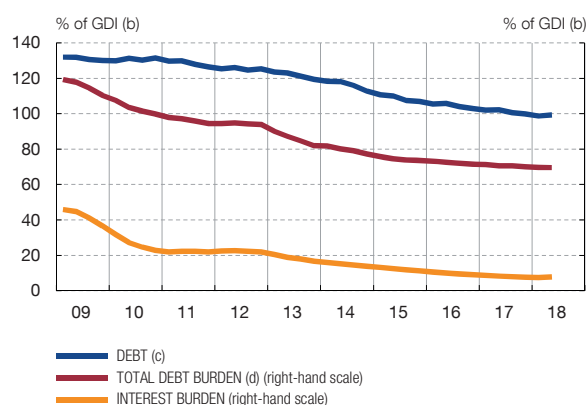
since 2010 (see Chart 10.3). The breakdown by purpose shows that this change is exclusively on account of the moderation in the rate of decline of lending for house purchase (0.7 pp since March, to 1.8% in July), offsetting the lower dynamism in the outstanding balance of consumer credit and other purposes loans (6.2% in July, compared with 6.6% four months earlier). It is estimated that the increase in the rate of growth of lending for house purchase is a result of the halt in the increase in the volume of repayments, interrupting the upward pattern of the last two years.

On the latest data available, the household debt ratio rose slightly in Q2, owing to the customary seasonal pattern of the debt balance in the second quarter, without this increase being offset by the growth in household income. In turn, the associated debt burden ratio was virtually unchanged in the period (see Chart 12.1). Households' net wealth rose again between March and June, on the back of the appreciation in the real estate component and, to a lesser extent, in the financial component (asset growth outpaced that of liabilities, see Chart 12.2).

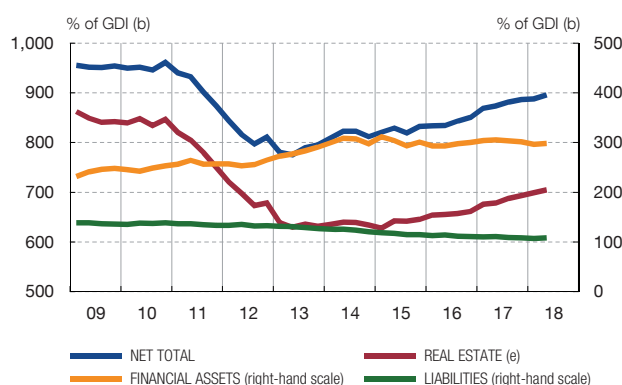
3.2 Business activity and investment

Business activity, proxied by the real value added of the market economy, appears to have grown at a slower pace in Q3 than in Q2, with a notable deceleration in industry and energy.

1 DEBT AND DEBT BURDEN RATIOS



2 WEALTH


[Dynamic chart](#)

SOURCES: INE and Banco de España.

- a The last data point in each series is an estimate.
 b Cumulative four-quarter data.
 c Includes bank lending and off-balance-sheet securitised lending.
 d Estimate of interest payments and repayments of principal.
 e Valuation based on estimated changes in stock of housing, average floor space and price per square metre.

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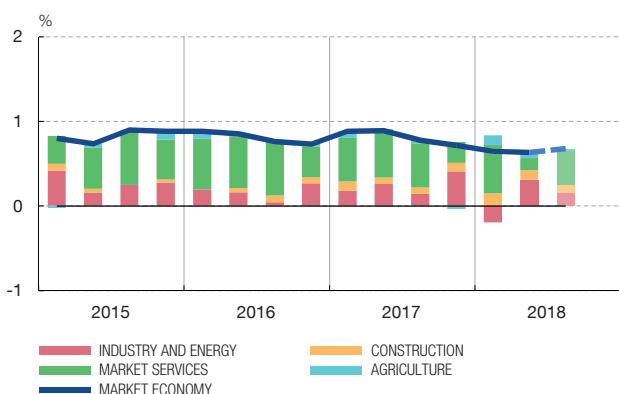
As regards business investment, the estimated increase in the capital goods component in Q3 is around 0.7% quarter-on-quarter, below the sharp increase recorded in Q2 (5.5%). The data available are still very limited, but the quantitative indicators, such as the capital goods IPI, point in this direction. For its part, investment in intangibles appears to have moderated compared with Q2. The good business investment momentum expected in the near and medium term would be consistent with a continuation of the upturn, in a setting in which capacity utilisation is at an all-time high.

The steady momentum in the cost of new bank lending to non-financial corporations has continued in recent months. Thus in July (the latest data available), the average interest rate applied to loans for less than €1 million was 2.6% (unchanged on four months earlier), while the average interest rate on loans for more than that figure was 1.7% (barely 0.1 pp more than in March). In turn, between March and August, the estimated cost of equity fell by 50 bp to 9.5%, while the estimated cost of long-term corporate debt issues rose by 10 bp to 2.4% and that of short-term issues remained unchanged (see Chart 10.2).

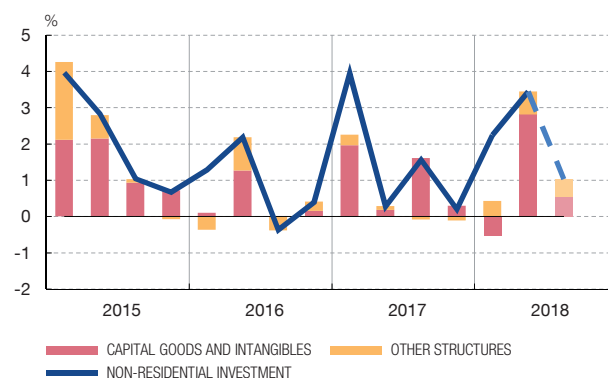
According to the replies to July's BLS, banks eased their credit standards for non-financial corporations in Q2, as overall terms and conditions also eased. The survey indicates that margins on average bank loans narrowed, while those on higher-risk exposures widened. Banks considered that demand remained stable. Looking ahead to Q3, they expected demand by non-financial corporations to rise sharply, with further easing in credit standards.

Against this backdrop of accommodative financing conditions, lending activity to corporations continued to grow in recent months, in comparison with previous quarters at a stronger pace in the case of new lending over €1 million and at a slower pace in the case of new lending under €1 million, the latter essentially reflecting lending to SMEs. In consequence, in terms of outstanding balances, the year-on-year rate of decline in loans

1 GROSS VALUE ADDED: MARKET ECONOMY (a)
Quarter-on-quarter rates and contributions



2 NON-RESIDENTIAL INVESTMENT (a)
Quarter-on-quarter rates and contributions



3 ACTIVITY INDICATORS



4 INVESTMENT INDICATORS (b)



SOURCES: INE, Ministerio de Fomento, Markit, Oficemen and Banco de España.

a Seasonally adjusted series.

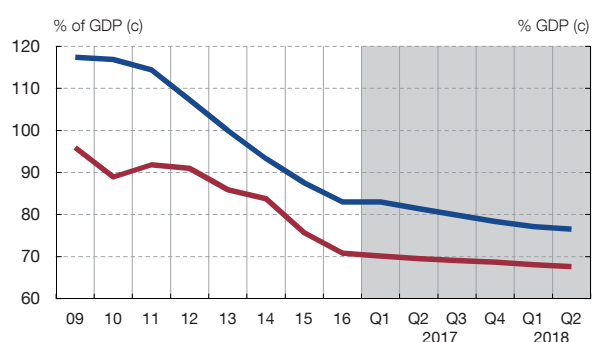
b 3-month moving average rates with three time lags, calculated on seasonally adjusted series. Dots depict quarter-on-quarter rate.



granted by resident institutions to non-financial corporations moderated, to 1.2% in July, 0.5 pp less than four months earlier (see Chart 10.4). In turn, financing obtained from issuance of debt securities (including issues by resident subsidiaries) continued to increase in year-on-year terms, posting a rate of growth of 5.5% in July, compared with 2.6% in March, an increase that to some extent reflects base effects. In the case of financing via loans from abroad, in recent months the rate of decline has intensified somewhat. Overall therefore, between March and July, the rate of contraction of total corporate sector debt moderated slightly, to 0.5% year-on-year in July.

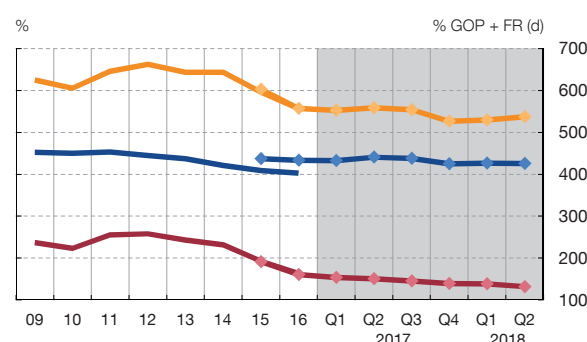
The financial position of non-financial corporations is estimated to have continued to strengthen in Q2, carrying on the trend of recent years. Thus, the debt-to-GDP ratio, which is now below that of the euro area, for the first time since 2002, has fallen, as a consequence of the growth in GDP which fully offset the small increase in debt (see Chart 14). The interest burden appears to have evolved similarly to the debt ratio, although its decline was also furthered by a slight decrease in the average cost of debt. According to the sample of non-financial corporations contributing to the Central Balance Sheet Data Office Quarterly Survey (CBQ), which are mainly large corporations, the rate of growth of ordinary profits was 11% year-on-year in Q2, compared with 7.1% in the same period a year earlier, thanks to the increase in productive activity and the favourable dynamic of financial

1 DEBT (a) AND INTEREST BURDEN. NATIONAL ACCOUNTS (b)

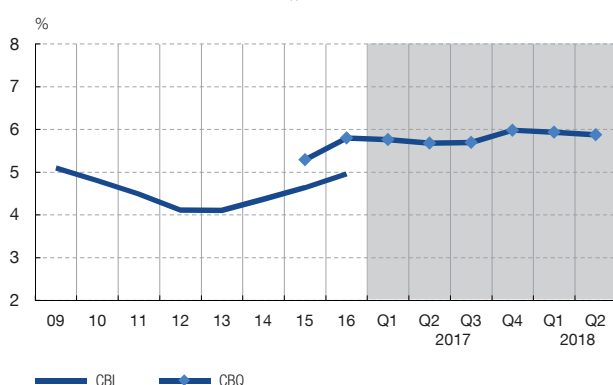


Dynamic chart

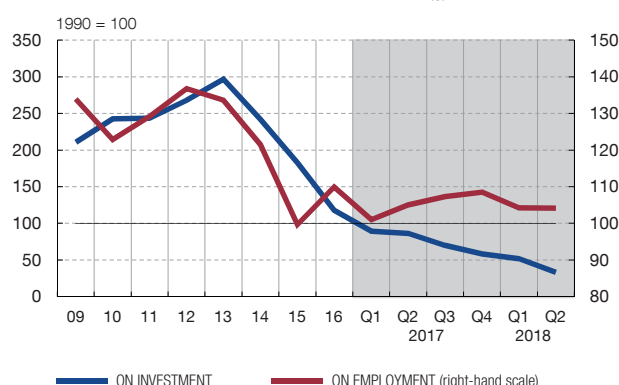
2 DEBT RATIO AND DEBT BURDEN. CBSO



3 RETURN ON INVESTMENT. CBSO (f)



4 SYNTHETIC INDICATORS OF FINANCIAL PRESSURE (g)



SOURCES: INE and Banco de España.

- a Interest-bearing borrowing.
- b The last data point in each series is an estimate.
- c The GDP data series is seasonally adjusted.
- d Gross operating profit (GOP) plus financial revenue (FR).
- e Total inflation-adjusted assets less non-interest bearing liabilities.
- f Ordinary net profit / net assets.
- g Indicators calculated on the basis of annual CBSO data, or quarterly data where no annual data are available. A value of more (less) than 100 denotes higher (lower) financial pressure than in the base year.

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revenue and costs.² As a result, return on investment rose to 4.2% in Q2, 0.2 pp more than a year earlier.

3.3 The external sector and the balance of payments

The still very limited information available for Q3 suggests that net external demand could again make a negative contribution to quarter-on-quarter growth in GDP in Q3, amounting to around 0.1 pp. This, in a setting characterised by an increase in foreign trade in goods and services, both in exports and imports, compared with the respective declines of 1% and 0.3% in Q2.³ In year-on-year terms, the contribution of net external demand to GDP

2 See Analytical Article "Results of non-financial corporations in the first half of 2018" <https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/ArticulosAnaliticos/2018/T3/Files/beaa1803-art23e.pdf> in *Economic Bulletin*, 3/2018, Banco de España.

3 The slowdown in external demand, together with the loss of competitiveness (which seems to come into play with a certain time lag), are responsible for most of the deceleration in Spanish goods exports in 2018 to date. In addition, the main reason for the loss of momentum in tourism appears to be the gradual return to normal in the geopolitical situation of some of Spain's main competitor destinations, such as Turkey and the countries of North Africa, see Box 6).

would be negative and similar to its contribution in the last quarter (-0.2 pp), against the backdrop of a slowdown in world trade, growing protectionist tensions and sharp exchange rate depreciation in some emerging economies (see Chart 15).

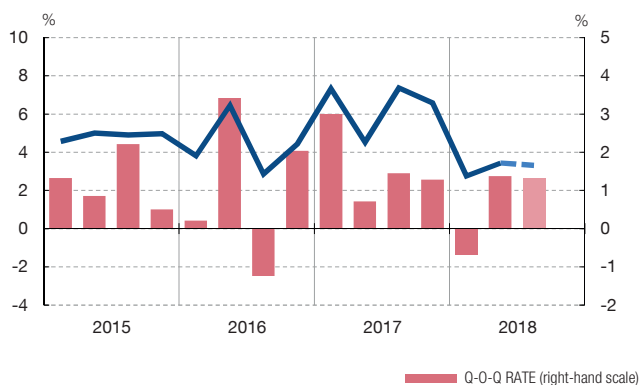
The only Customs data available for the third quarter are those of July. According to them, real flows of exports and imports of goods increased substantially, recording year-on-year growth rates of 6.3% and 4.9%, respectively. This does not necessarily mean that the phase of greater slackness observed during the first half of the year has been interrupted. Rather, this acceleration could basically be associated with calendar factors, making it unlikely for it to continue in the third quarter. The breakdown of exports by product shows that foreign sales of intermediate goods, particularly energy and capital goods, increased significantly. By geographical region, the main increase was in exports to EU markets. Non-EU exports grew much more moderately, probably, as in the case of the first half-year, owing to the effects of the loss of competitiveness arising from the exchange rate, built-up vis-à-vis these markets. On the side of purchases abroad of goods in real terms, imports of non-food consumer goods and non-energy intermediate products gained momentum.

Foreign tourist arrivals decreased by 4.9% in July compared to a year ago, when all-time highs were reached, accentuating the slowdown recorded since end-2017. This was in line with the gradual return to normal and recovery of our main competitor destinations in the Mediterranean region, against a background, in addition, of notable appreciation of the euro against these countries' currencies (especially the Turkish lira). Other sporadic events, such as the unusual heat wave in continental Europe, the FIFA World Cup held in Russia or air transport strikes, could have influenced July tourism records somewhat negatively. There was a substantial decline in July in the number of tourists from Spain's main source markets, such as the United Kingdom, Germany and France, although the buoyancy of other more distant markets continued, particularly that of tourists from the United States. Despite the increase in tourists' daily average expenditure (9.5% year-on-year) and, to a lesser extent, in average spending per tourist (4.2% year-on-year), total spending decreased slightly in July (0.9% year-on-year), but grew 3% year-on-year during the seven first months of the year.

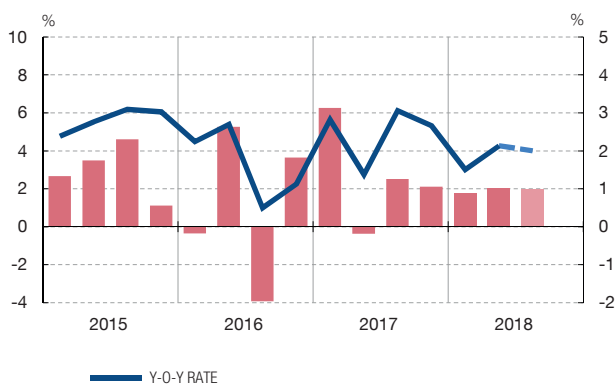
The Spanish economy's net lending position decreased in the most recent period. Specifically, on cumulative 12-month data, the balance-of-payments surplus declined to 1.7% of GDP (from 2.1% in 2017 as a whole). This resulted from the deterioration of the balance of goods and non-tourism services – in part owing to the escalation of oil prices – and, to a lesser degree, the increase in the primary and secondary income deficits, partially offset by an improvement in the tourism surplus and the increase in the positive balance of the capital account.

The most recent data available on cross-border financial flows show that the financial account of the balance of payments, excluding the Banco de España, had a credit balance of €20.5 billion in 2018 Q2. This performance was the result of an increase in holdings of foreign assets by resident agents (€31.4 billion), which exceeded the net increase in liabilities issued by them vis-à-vis the rest of the world (€9.9 billion), and the slightly negative net flow (around €900 million) of transactions associated with financial derivatives. On the assets side, the positive net flow was the outcome of investments under the heading of other investments (€17.1 billion), followed by direct investment (€8.5 billion), which related to equity, and portfolio investment (€5.8 billion), mainly debt securities. On the liabilities side, net investments in Spain by foreigners concentrated in direct investment

1 EXPORTS OF GOODS AND SERVICES (a)



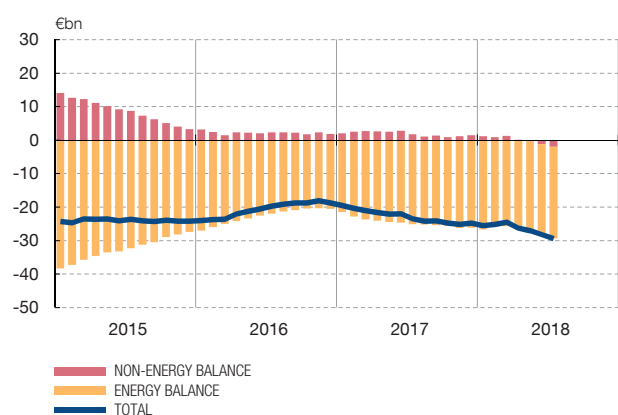
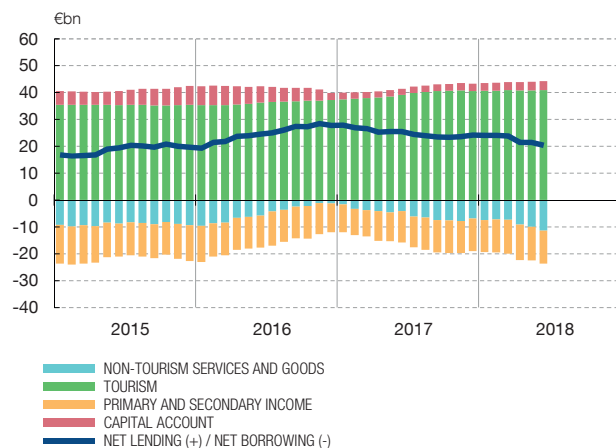
2 IMPORTS OF GOODS AND SERVICES (a)



3 CUSTOMS INDICATORS (b) (c)



4 TOURISM INDICATORS (c)

5 FOREIGN TRADE IN GOODS
Cumulative figures for last 12 months6 BREAKDOWN OF CURRENT AND CAPITAL ACCOUNT (d)
Cumulative figures for last 12 months

SOURCES: INE, Ministerio de Economía y Empresa and Banco de España.

a QNA data at constant prices. Seasonally adjusted series.

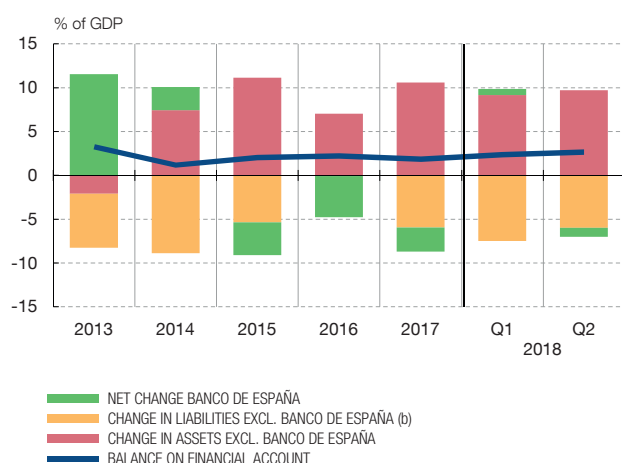
b Series deflated using export (IPRIX) and import (IPRIM) price indices for industrial products.

c 3-month moving average rates with three time lags, calculated on seasonally adjusted series. Dots depict quarter-on-quarter rate.

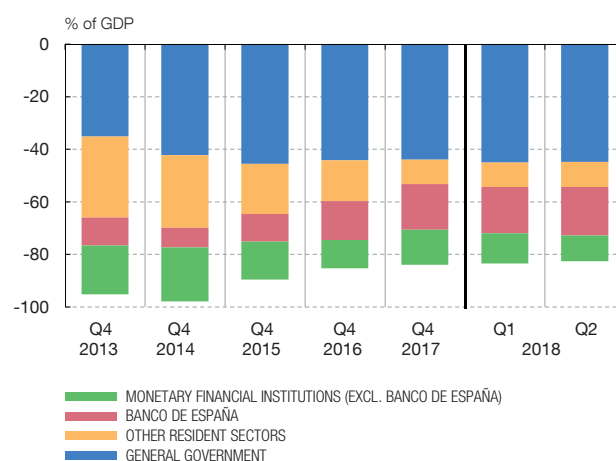
d Data conform to the sixth edition of the IMF's *Balance of Payments and International Investment Position Manual* (BPM6).

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1 FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS (a)



2 INTERNATIONAL INVESTMENT POSITION (c)



SOURCE: Banco de España.

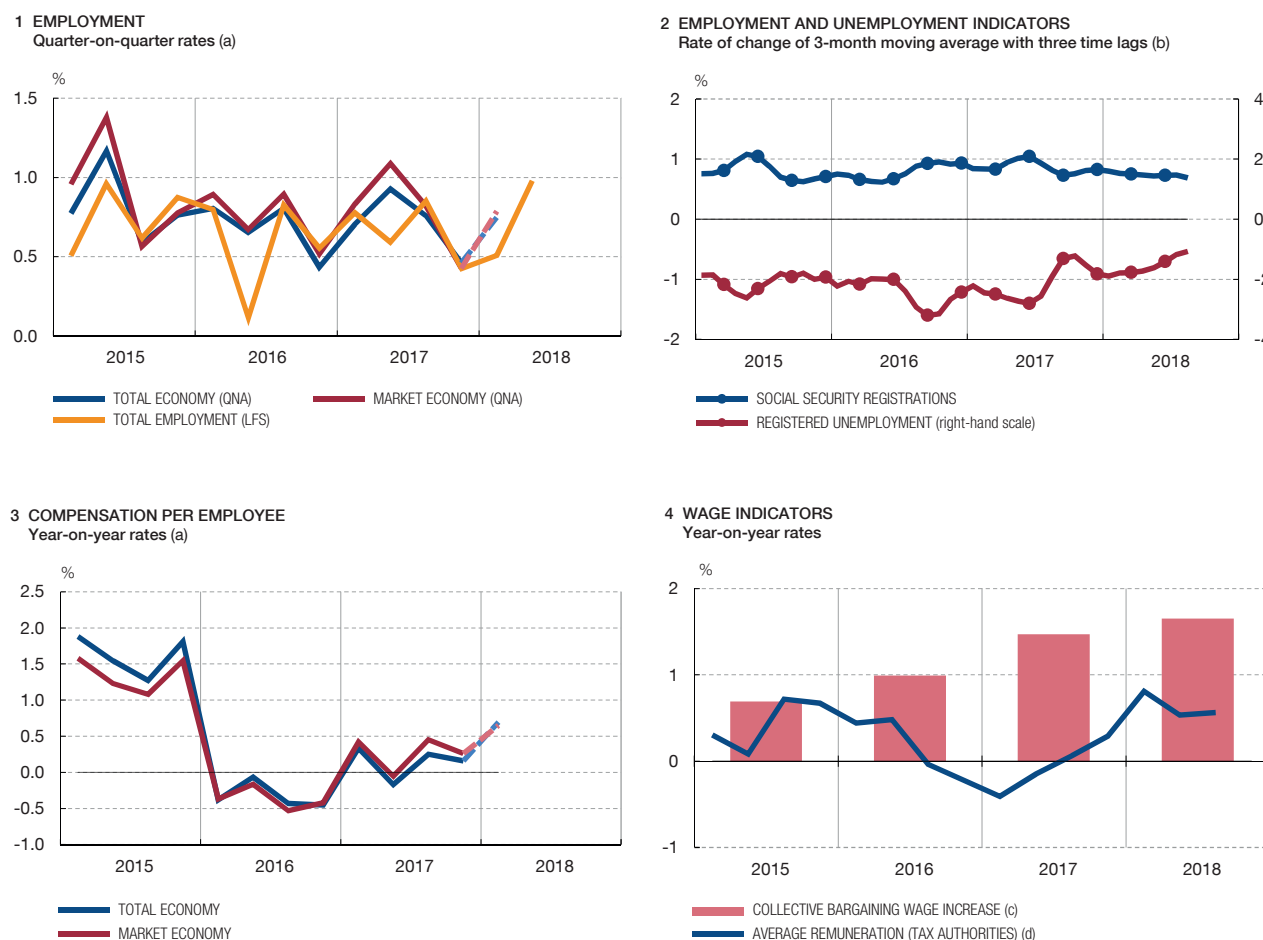
- a Four-quarter cumulative quarterly data.
 b Sign changed.
 c Assets minus liabilities vis-à-vis the rest of the world.



(€21.2 billion), particularly in shares of non-financial corporations, since, unlike in recent quarters, they divested from portfolio investment (€1.9 billion) and, especially, other investment (€9.3 billion).

By institutional sector, net flows vis-à-vis the rest of the world were positive for other resident sectors (€13 billion) and for other monetary financial institutions (€12.5 billion), in line with their net lending position, while general government raised funds from abroad in net terms (€5 billion). The net balance of the financial account, excluding the Banco de España, exceeded the Spanish economy's net lending position of €3 billion. Together with errors and omissions amounting to €3 billion, this resulted in a strong increase in the Banco de España's net debtor position (€14.5 billion) vis-à-vis the rest of the world. This increase was also reflected in cumulative 12-month terms, since the Banco de España moved from a net credit balance (assets minus liabilities) in Q1 (of €8.2 billion) to a debit balance in June (of €12.2 billion), thus returning to the dynamics it had shown since the start of the Eurosystem's asset purchase programme (see Chart 16.1).

The most recent information available on the international investment position (IIP) shows the Spanish economy's net debt to the rest of the world to have decreased by €3.5 billion in the second quarter of 2018, to 82.6% of GDP, almost 1 pp less than three months earlier (see Chart 16.2). This reduction in the debit balance resulted from the positive amount of net financial transactions (€6 billion), which fully offset the negative amount of other flows (–€2.4 billion). The performance of the latter was driven by a decrease in the value of assets exceeding that of liabilities. In the case of assets, the fall resulted from price changes, especially in equity instruments, which were not offset by the effects of the depreciation of the euro. The net losses in the value of liabilities, which were mainly also due to changes in prices, materialised mostly in debt securities. Spain's gross external debt decreased weakly, by 0.1 pp, in terms of GDP, to 168.2%, which is 6.4 pp less than the peak reached in 2018 Q1.



SOURCES: INE, Ministerio de Trabajo, Migraciones y Seguridad Social, Agencia Tributaria and Banco de España.

- a Rates of change calculated on adjusted series. QNA employment measured in full-time equivalent job terms.
b Calculated on seasonally adjusted series at the Banco de España. Dots depict quarter-on-quarter rate.
c With data to August 2018. Excludes indexation clauses.
d Seasonally adjusted series. Last quarter, with data only for July 2018.



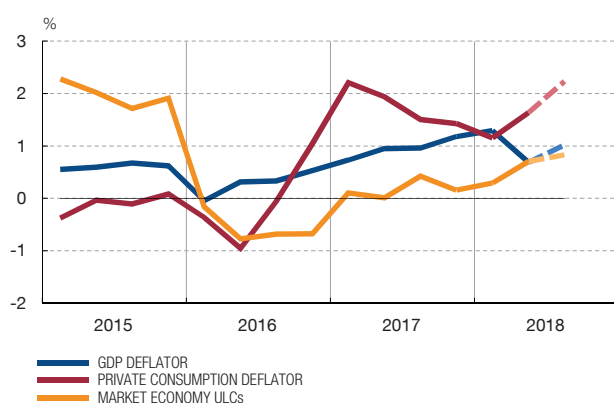
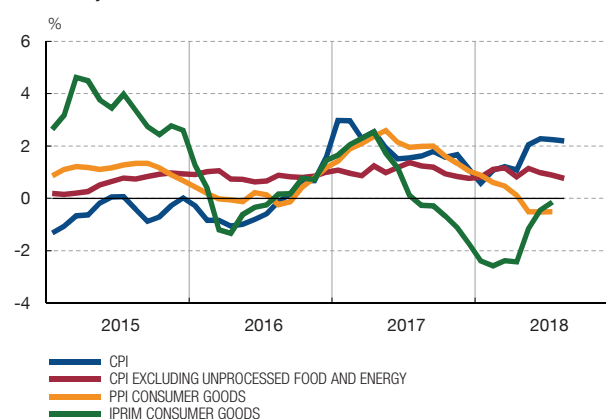
3.4 The labour market

Employment accelerated in 2018 Q2, posting quarter-on-quarter growth of 0.8%, 0.3 pp higher than in Q1, in line with changes observed by the Spanish Labour Force Survey. However, the most recent labour market indicators point to a slight moderation of the dynamism of employment in the third quarter of the year. Social Security registrations in July and August posted lower month-on-month increases than those recorded in Q2. By sector, an acceleration was observed in construction, which maintains the highest growth rates together with non-market services, whose pace of growth remained stable. Conversely, Social Security registrations in agriculture, industry and market services slowed down. This information suggests that employment in Q3, measured in QNA terms,⁴ could rise 0.5% in the total economy and 0.6% in the market economy, which would entail a decrease in the growth rate of 0.3 pp in both cases (see Charts 17.1 and 17.2).

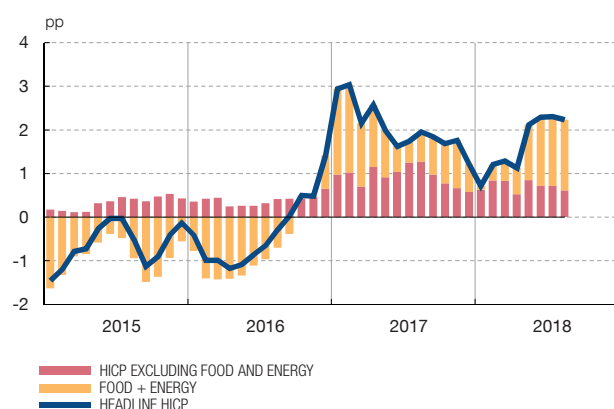
The rate of decline of unemployment registered by the National Public Employment Service (SEPE by its Spanish abbreviation) continued on the moderate path seen since the beginning of the year, reaching 1.1% in August, in terms of the three-month seasonally

⁴ In terms of full-time equivalent jobs.

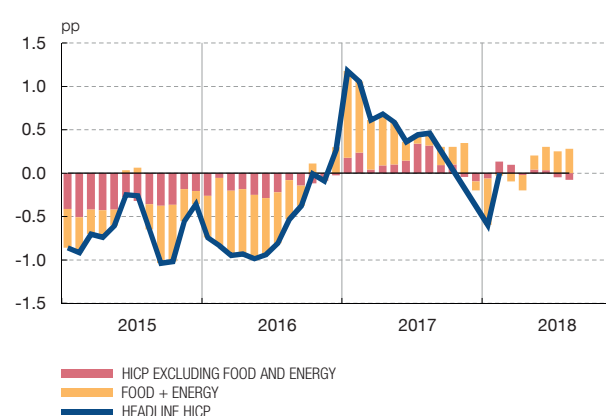
1 GDP DEFLATOR AND UNIT LABOUR COSTS (a)

2 PRICE INDICATORS
Year-on-year rates

3 CONTRIBUTIONS TO HICP YEAR-ON-YEAR GROWTH RATE



4 CONTRIBUTIONS TO SPANISH-EURO AREA INFLATION DIFFERENTIAL



SOURCES: INE, Eurostat and Banco de España.

a Year-on-year rates of change calculated on seasonally adjusted series.



adjusted moving quarter-on-quarter rate (see Chart 17.2). The new contracts registered by the SEPE grew on average in the July-August period by more than in H1. The faster pace of hiring affected permanent contracts more than temporary ones, such that the share of permanent contracts in relation to a year ago rose by almost 2 pp, reaching 9.6% of the total.

As regards wages, the information on collective bargaining agreements registered until August shows a wage increase of 1.7%, 0.2 pp higher than agreed for 2017, with coverage for 7.5 million employees. The increase in wage rates was observed both in revised agreements (1.6%, compared with 1.3% in 2017) and in newly signed ones, the increase agreed being slightly higher in the latter case (2% for 2018). However, it is still early to detect the possible impact of the Agreement for Employment and Collective Bargaining that was signed in June by the social agents. By contrast, the information published by the tax collection agency on average gross pay at large non-financial corporations showed that it maintained its year-on-year rate of increase by 0.6% in July in terms of the seasonally-adjusted series. On QNA data for Q2, compensation per employee picked up somewhat, close to 0.4 pp, in both the total and the market economy, posting year-on-year growth rates of 0.7% and 0.9%, respectively. This course of acceleration is expected

to continue in Q3, with a rise of 1.2% in the case of the market economy and somewhat stronger in the total economy (see Charts 17.3 and 17.4).

3.5 Price developments

In 2018 Q3, it is estimated that the year-on-year growth of the imports deflator will have increased notably, against a background of higher oil prices, prolonging its upward trend. The year-on-year rate of increase of overall domestic producer prices, proxied by the GDP deflator, continued to be moderate in Q3, while that of the private consumption deflator is estimated to have increased slightly (see Chart 18.1).

The year-on-year rate of change of the HICP was 2.2% in August, 0.1 pp higher than in May.⁵ In turn, the inflation rate for the euro area as a whole increased in August by 0.1 pp relative to May, to 2% year-on-year. As a result, Spain's inflation differential vis-à-vis the euro area is estimated to stand at 0.2 pp, the same as in May.

The acceleration of the overall HICP is the result of the trajectory of energy prices, whose year-on-year rate increased by 3.3 pp between May and August, affected by oil price developments and higher electricity prices. For its part, the year-on-year growth rate of food prices held at 2%. Core inflation, measured by the HICP excluding energy and food, eased by 0.3 pp to 0.9%, reflecting the deceleration of services prices by 0.6 pp, to 1.2%, while the rate of change of non-energy industrial goods prices remained stable, at 0.3%.

21.9.2018

⁵ Likewise, the consumer price index (CPI) in August increased by 2.2% year-on-year, 0.1 pp above the rate of change in May, despite the slowing of the CPI excluding unprocessed food and energy by 0.3 pp relative to that month, to 0.8%.

ANALYTICAL ARTICLES

Chronology of Analytical Articles. 2018 Q3.

RESULTS OF NON-FINANCIAL CORPORATIONS IN THE FIRST HALF OF 2018

Álvaro Menéndez and Maristela Mulino

Published on 20 September 2018

According to data from the Central Balance Sheet Data Office Quarterly Survey, non-financial corporations continued to see an increase in activity, employment and ordinary profits in the first half of 2018, supporting a continued recovery in aggregate profitability levels. There was no significant change in debt ratios, while the debt burden continued to fall, reaching historic lows, indicating that financial pressure on the corporate sector is currently low. Nevertheless, the simulations included with this article reveal that certain segments of the corporate sector would be particularly vulnerable to rising borrowing costs

CREDITOR COUNTRIES AND DEBTOR COUNTRIES: SOME ASYMMETRIES IN THE DYNAMICS OF EXTERNAL WEALTH ACCUMULATION

Ángel Estrada and Francesca Viani

Published on 6 September 2018

Following the global financial crisis, the external imbalances in terms of countries' current account balances have been reduced to a large extent. However, the imbalances measured in terms of net external wealth (or net international investment position, NIIP) have continued to increase. The empirical analysis presented in this article suggests that there is asymmetry between net debtor countries (negative NIIP) and net creditor countries (positive NIIP), with potential implications for global trade and growth. In the case of debtors, their negative NIIP contributes to reducing current account deficits and is therefore a stabilising factor. Conversely, in the case of the creditors, the NIIP contributes to increasing current account surpluses which, in turn, strengthens the dynamics of wealth accumulation in these countries, compared with the rest of the world.

MONETARY POLICY IMPLICATIONS OF CENTRAL BANK-ISSUED DIGITAL CURRENCY

Galo Nuño

Published on 30 July 2018

This article analyses the concept of digital currency issuable by a central bank, highlighting its similarities to and differences from the two main liabilities on its balance sheet: cash and bank reserves. It also discusses the main reasons why some central banks are looking into the potential consequences of the introduction of this new instrument. Lastly, it considers different central bank digital currency alternatives and highlights some of the possible implications for monetary policy conduct and for financial stability.

THE JULY 2018 BANK LENDING SURVEY IN SPAIN

Álvaro Menéndez Pujadas

Published on 24 July 2018

The results of the Bank Lending Survey show that during 2018 Q2 credit standards for new loans eased slightly in all segments, both in Spain and in the euro area. Household demand for credit grew in both areas, while that from enterprises did so only in the euro area, holding stable in Spain. As regards funding, both Spanish and euro area banks generally perceived some improvement in access conditions to retail markets and a slight deterioration in practically all wholesale markets. During the first half of 2018, regulatory and supervisory measures are estimated to have been conducive, in both areas, to some increase in capital levels, and, in the case of the euro area, also in assets. According to Spanish banks, these measures are not expected to have appreciably impacted either their funding conditions or lending standards or margins on loans. In the case of the euro area, they provided for some easing in institutions' funding conditions, along with a slight tightening in credit standards, not significantly affecting the margins applied in most segments. Banks in both areas highlighted, as the key factors for the setting of their margins, the search for yield and competitive pressures. Finally, the NPL ratio has not significantly affected Spanish institutions' lending policies during the first half of 2018, while it has contributed to some tightening in the euro area.

INVESTMENT AND FINANCING OF SPANISH NON-FINANCIAL CORPORATIONS: AN ANALYSIS USING FIRM-LEVEL DATA

Daniel Dejuán, Álvaro Menéndez and Maristela Mulino

Published on 12 July 2018

According to the analysis conducted in this article, based on individual firms' balance sheet information, Spanish corporate investment tended to pick up from 2014 and to do so with greater intensity at SMEs than at large corporations, after having contracted more forcefully during the early stages of the crisis at SMEs. In any event, as regards the stock of productive assets (tangibles and intangibles alike), the investment level attained in 2016 is expected to still be below pre-crisis figures. Analysis of investment determinants highlights the fact that the strength of the financial position and of profitability are positively related to business investment decisions, especially during the post-crisis period. As to the sources of financing used, firms with net positive investment resorted, throughout the period, both to own and borrowed funds, although the relative weight of the latter fell significantly from 2008. Firms investing intensively in intangibles – which were financed, until 2007, both with own and borrowed funds – began, with the onset of the crisis, to depend practically exclusively on own funds. That suggests the possible existence of greater difficulties for firms with a high concentration of intangible assets in gaining access to borrowed funds.

RECOURSE TO EUROSISTEM FUNDING BY SPANISH BANKS

Ricardo Gimeno and Ana del Río

Published on 5 July 2018

During the crisis, euro area banks' recourse to Eurosystem funding facilities was closely related to the severe tensions in the funding markets. However, since the latter part of 2014, Eurosystem refinancing operations have been essentially determined by the implementation of the single monetary policy and the need to reinforce the monetary stimulus by means of non-standard measures. The Spanish banking system currently has a relatively high level of recourse to Eurosystem funding, as a proportion of GDP and in terms of its weight in the banking sector balance sheet, although its share of total Eurosystem funding has fallen since 2014. The long maturities of this funding and the favourable conditions in the financial markets in the more recent period have afforded banks more scope to refinance or repay these debts in an orderly manner.

TRADE PATTERNS OF CHINA AND INDIA

Elena Vidal

China and India are playing an increasingly significant role in global trade. In 2016, their joint share of the global trade in goods reached around 14%, while their share of services came to 7.5%. They have very different trade profiles, however, also reflecting very different internationalisation strategies. Since opening up in the 1980s, China has taken on a global trade hub role, thanks to its growing integration into global production chains for manufactured goods. More recently, China has undergone a shift in trade specialisation towards a pattern characterised by the export of products with higher domestic value added (i.e. it has moved up the global value chain). India's integration into global value chains has been much more limited and, since the early stages of its economic liberalisation, services have accounted for a substantial share of its exports. Although India's export profile has remained fairly stable in recent decades, a growing weight of manufacturing exports with a greater import content has recently become discernible. Against this background, the estimation of goods export demand equations shows how, in the long run, external demand is the factor that yields most influence on developments in both countries' exports, albeit more powerfully so in China, while price-competitiveness has a greater influence on Indian exports.

ECONOMIC NOTES

Chronology of Economic Notes. 2018 Q3.

REFERENCE VARIABLES FOR ANALYSING INFLATION IN SPAIN

Luis Julián Álvarez and Isabel Sánchez

Published on 14 September 2018

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ACRONYMS AND ABBREVIATIONS

ABS	Asset-backed securities	GDP	Gross domestic product
APP	Asset Purchase Programme	GFCF	Gross fixed capital formation
BCBS	Basel Committee on Banking Supervision	GNP	Gross national product
BE	Banco de España	GOP	Gross operating profit
BIS	Bank for International Settlements	GVA	Gross value added
BLS	Bank Lending Survey	HICP	Harmonised Index of Consumer Prices
BOE	Official State Gazette	IASB	International Accounting Standards Board
CBA	Central Balance Sheet Data Office Annual Survey	ICO	Official Credit Institute
CBQ	Central Balance Sheet Data Office Quarterly Survey	IFRSs	International Financial Reporting Standards
CBSO	Central Balance Sheet Data Office	IGAE	National Audit Office
CCR	Central Credit Register	IIP	International Investment Position
CDSs	Credit default swaps	IMF	International Monetary Fund
CESR	Committee of European Securities Regulators	INE	National Statistics Institute
CNE	Spanish National Accounts	LTROs	Longer-term refinancing operations
CNMV	National Securities Market Commission	MFIs	Monetary financial institutions
CPI	Consumer Price Index	MROs	Main refinancing operations
CSPP	Corporate sector purchase programme	MTBDE	Banco de España quarterly macroeconomic model
DGF	Deposit Guarantee Fund	NAFTA	North American Free Trade Agreement
EBA	European Banking Authority	NAIRU	Non-accelerating-inflation rate of unemployment
ECB	European Central Bank	NCBs	National central banks
ECOFIN	Council of the European Communities (Economic and Financial Affairs)	NFCs	Non-financial corporations
EDP	Excessive Deficit Procedure	NiGEM	National Institute Global Econometric Model
EFF	Spanish Survey of Household Finances	NPISHs	Non-profit institutions serving households
EFSF	European Financial Stability Facility	OECD	Organisation for Economic Co-operation and Development
EMU	Economic and Monetary Union	ONP	Ordinary net profit
EONIA	Euro overnight index average	OPEC	Organisation of Petroleum Exporting Countries
EPA	Official Spanish Labour Force Survey	PER	Price/earnings ratio
ESA 2010	European System of National and Regional Accounts	PMI	Purchasing Managers' Index
ESCB	European System of Central Banks	PPP	Purchasing power parity
ESFS	European System of Financial Supervisors	QNA	Quarterly National Accounts
ESM	European Stability Mechanism	SAFE	ECB Survey on the Access to Finance of Enterprises
ESRB	European Systemic Risk Board	SDRs	Special Drawing Rights
EU	European Union	SEPA	Single Euro Payments Area
EURIBOR	Euro interbank offered rate	SGP	Stability and Growth Pact
EUROSTAT	Statistical Office of the European Communities	SMEs	Small and medium-sized enterprises
FASE	Financial Accounts of the Spanish Economy	SRM	Single Resolution Mechanism
FDI	Foreign direct investment	SSM	Single Supervisory Mechanism
FROB	Fund for the Orderly Restructuring of the Banking Sector	TFP	Total factor productivity
FSB	Financial Stability Board	TLTROs	Targeted longer-term refinancing operations
FSF	Financial Stability Forum	ULCs	Unit labour costs
GDI	Gross disposable income	VAT	Value Added Tax
		WTO	World Trade Organization

COUNTRIES AND CURRENCIES

In accordance with Community practice, the EU countries are listed using the alphabetical order of the country names in the national languages.

BE	Belgium	EUR (euro)
BG	Bulgaria	BGN (Bulgarian lev)
CZ	Czech Republic	CZK (Czech koruna)
DK	Denmark	DKK (Danish krone)
DE	Germany	EUR (euro)
EE	Estonia	EUR (euro)
IE	Ireland	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IT	Italy	EUR (euro)
HR	Croatia	HRK (Croatian kuna)
CY	Cyprus	EUR (euro)
LV	Latvia	EUR (euro)
LT	Lithuania	EUR (euro)
LU	Luxembourg	EUR (euro)
HU	Hungary	HUF (Hungarian forint)
MT	Malta	EUR (euro)
NL	Netherlands	EUR (euro)
AT	Austria	EUR (euro)
PL	Poland	PLN (Polish zloty)
PT	Portugal	EUR (euro)
RO	Romania	RON (New Romanian leu)
SI	Slovenia	EUR (euro)
SK	Slovakia	EUR (euro)
FI	Finland	EUR (euro)
SE	Sweden	SEK (Swedish krona)
UK	United Kingdom	GBP (Pound sterling)
JP	Japan	JPY (Japanese yen)
US	United States	USD (US dollar)

CONVENTIONS USED

M1	Notes and coins held by the public + sight deposits.
M2	M1 + deposits redeemable at notice of up to three months + deposits with an agreed maturity of up to two years.
M3	M2 + repos + shares in money market funds and money market instruments + debt securities issued with an agreed maturity of up to two years.
Q1, Q4	Calendar quarters.
H1, H2	Calendar half-years.
bn	Billions (10 ⁹).
m	Millions.
bp	Basis points.
pp	Percentage points.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
0.0	Less than half the final digit shown in the series.